Investment Outlook

Slowly, but in the right direction

INVESTMENT OUTLOOK SUMMARY

December 2014

Brief world economic outlook

The world economy continues to climb further, led by the United States, while the world's central banks are expected to remain supportive of financial markets in general and riskier asset classes in particular. However, the global economic upturn is still fragile, but the determination of economic policymakers should meanwhile not be underestimated. This is especially true of monetary policymakers (central banks), who have made the battle against deflation their highest priority. There are also hints of greater acceptance for more expansionary fiscal policies. Overall, the world economy appears capable of growing faster in 2015 and 2016 than this year. Thanks to falling energy prices, the probability of unexpectedly high growth has increased, while heightened tensions between Russia and other countries continue to pose a risk to growth.

Looking ahead, world economic growth will accelerate according to SEB's forecast. After this year's 3,5% GDP increase, global growth will be 3,8% in 2015 and 3,9% in 2016. Emerging market (EM) countries will continue to grow the fastest, almost 5% yearly in 2015-2016, but the gap between EM and developed market (DM) countries will shrink next year as DM growth accelerates to 2,4%, following this year's 1,9%. In 2016, the EM sphere will continue to grow about twice as fast (4,9%) as DM countries (2.4%).

The US economy is doing well...
After the weather-related decline in gross domestic product (GDP) during the first quarter of 2014, US growth accelerated significantly. Both a strong labor market and better household sentiment indicate that private consumption is about to strengthen greatly. We expect GDP to grow by 2,2% this year, 3,4% next year and 3,1% in 2016. Looking ahead, good growth will be coupled with far lower inflation due to a stronger US dollar and cheaper oil. This will persuade the Federal Reserve (Fed) to hold off on its first key interest rate hike until September 2015. Since 2010, the federal government has been highly successful in reducing its budget deficit, which has shrunk from more than 10% to less than 3% of GDP in only four years.

...while the euro zone is doing worse
Euro zone GDP grew by only 0,2% in the third quarter, with many countries facing low demand and struggling with structural problems. Germany's economy has lost momentum, while Spain's has been surprisingly strong. Because of near stagnation in the euro zone economy and the risk of deflation, the European Central Bank (ECB) has expanded its stimulus programmes. There have been cautious steps towards easing fiscal policies. The new president of the European Commission, Jean-Claude Juncker, has unveiled a plan to boost infrastructure investments. The weakening euro will also help exporters, and falling oil prices will boost household purchasing power while lowering company costs. But we predict that euro zone GDP will increase by a mere 0,9% both this year and next, accelerating to 1,3% in 2016.

Accelerating growth in emerging Asia
There is good potential for faster growth in most Asian EM countries. Strong labor markets are helping to drive domestic demand. Increased world market demand will also provide a helping hand. Economies in an especially good position are South Korea, Singapore and Taiwan, while countries with large current account deficits such as Indonesia are vulnerable. Low inflation in the region will allow continued supportive monetary policies. In China, increased exports are partly offsetting sluggish domestic demand. Slower growth will give Chinese authorities a reason to continue with targeted measures and persuade the central bank to lower its lending rate further. We expect GDP to expand by 7,4% this year, 7,0% next year and 6,7% in 2016. India will benefit greatly from cheaper oil, which will lower inflation and give the central bank a reason to cut its key interest rate in 2015. The government of N. Modi has not yet really met expectations of speedy reform efforts, but conditions are now in place for more far-reaching reforms that will decrease structural problems and benefit growth. We predict that India's GDP will increase by 5,3% this year, reaching 5,8% in 2015 and 6.2% in 2016.

Latin American macroeconomic curves point the wrong way
This year, most macroeconomic curves have been pointing in the wrong direction in Latin America. Growth has slowed, inflation has increased and deficits in both the current account and public finances have become larger. The Brazilian economy is stagnating and the outlook is not especially promising, especially since there is little confidence in the ability of newly re-elected President D. Rousseff to get the economy back on track. In Argentina there is very high inflation, which will probably be even higher in 2015. Financial ratios are far more favorable in Mexico and Chile. We expect overall Latin American GDP to grow by 1% this year, 2% in 2015 and 3% in 2016.

Mixed economic outlook for Eastern Europe
We expect the Russia-Ukraine conflict to be lengthy, leading to recession in Russia during 2015 and economic stagnation in Ukraine. Yet gradual recovery will continue in much of Central and South-Eastern Europe, due to the continued expansion of private consumption, increased exports to the West and cheaper oil, which will benefit many of the countries that are large energy importers. Economic policies, on the other hand, will not do much to stimulate growth. Countries whose economies are especially hurt by large trade exposure to Russia are former Soviet republics in Central Asia, Finland and the Baltic countries. During 2014, the Baltic economies were pulled down by Russia's decelerating growth and its import ban, as well as by the euro zone slump. Capital spending in the Baltics has been persistently weak, while construction and especially household consumption have been positive forces. The Russia-Ukraine conflict will hamper Baltic exports in 2015 as well. Private consumption will thus continue to be the main growth engine. Consumption will benefit especially because wages and salaries adjusted for (low) inflation will climb by a rapid 4-5% annually. The prospects of somewhat higher exports to Western Europe and a weaker euro will also be positive growth factors.

Theme

Alternative paths for world economy
The economic upturn now under way began in the summer/autumn of 2009 and ever since then has been unusually slow in many countries. For instance, in the US, this recovery has been the weakest so far of the entire post-war period. Meanwhile, financial assets have climbed significantly in value. Since the spring of 2009, investments in global equities have generated an average annual return of 20 per cent, while the corresponding figures for corporate bonds and government bonds have been 11 and 6 per cent, respectively. Economic and financial market trends in recent years have certainly been unusual, which naturally raises the question of how things will unfold in the years ahead.

Our main scenario is still that the economic upturn now under way will continue for quite a while and at a moderate pace. But this, of course, does not rule out the global economy instead taking an alternative path. The aim of this theme article is to examine three such alternatives and see how different types of financial assets might perform.

1) A more unfavorable scenario for the next few years would be if Europe, the US and Japan were to pursue an economic path like the one taken by Japan in the 1990s/early 2000s. Among the factors underlying the Japanese crisis were speculative bubbles in real estate and equities during the 1980s, which were punctured in 1989-1990 by the Bank of Japan (BoJ)'s sharp tightening of monetary policy. This tightening was the catalyst for the combination of stagnation, recurring recessions and deflation that was predominant in Japan for more than a decade. In the period 1992-2003, Japanese GDP per capita grew at an annualized average rate of just over 0,5%, while consumer prices were generally stable.

2) A second scenario is "secular stagnation", which can be defined as a condition in which average economic growth over a decade or more is far slower than the long-term trend, while inflation and interest rates are also low. Its characteristics include weak demand for goods and services along with a high level of savings, resulting in unemployment and large unutilized production capacity.

3) The global economy may of course also exceed our expectations in the years ahead, in terms of growth and improved economic strength and balance. Driving forces in such a scenario might be economic structural reforms in the euro zone, Japan and India; a rapid and smooth transition from investment-led to consumption-led growth in China; the absence of dramatic commodity price hikes; and the establishment of lower oil prices mainly as a result of the energy revolution in the US, which is becoming increasingly self-sufficient. Other potential drivers are progress in efforts to deregulate and expand global trade and an easing of geopolitical tensions. One important piece in this positive scenario puzzle would be several years of sustained healthy economic growth in the US, which would also have beneficial effects on the rest of the world economy.

Consequences for financial assets. By all indications, a repeat of the 1990s Japanese crisis would be devastating for equities. During that crisis, the Tokyo Stock Market fell sharply – by an annual average of about 4%.

A secular stagnation scenario would in itself be beneficial for fixed income investments, but given today's historically low bond yields, there would be very little room for a fall in yields/rise in prices. Slow growth, small price increases and low interest rates would together pave the way for low returns on equity investments. Sectors that initially have low valuations, and companies with high dividend yields and/or stable growth, should do better than the stock market in general.

In a surprisingly positive global economic scenario, there is a clear upside for equities, since the risk premium for equities (corporate earnings/share price minus government bond yield) is now high. This reflects low growth expectations and great uncertainty about economic prospects. If these expectations are exceeded and uncertainty diminishes, cyclical equities and companies with high expected earnings would benefit at the cost of defensive equities and companies with stable growth. Financial service shares may also be among the winners in that case. The risk premium on government bonds is currently quite low, which as such clearly signals a risk of rising interest rates in an unexpectedly good scenario.

Expected risk and return in asset classes in the next 12 months

Our risk and return expectations are taken from the SEB House View. These expectations cover the next 12 months. For **equities**, the forecast refers to the global stock market. For **fixed income**, the forecast refers to a basket of ½ investment grade and ½ high yield corporate bonds (average duration 5,5 years). The **hedge funds** forecast refers to HFRX Market Neutral Index which follows market neutral strategy. The **real estate** forecast refers to the real estate market (EPRA index), while the **commodities** forecast refers to a basket of energy (33%), industrial metals (19%), agricultural (36%) and precious metals (13%). Private equity forecast refers to the world largest listed **private equity** companies which are included in LPX Total Return and MSCI AC World LOC indexes. As for **currencies**, the forecast refers to most central currency pair EUR/USD.

Asset class	Expectations next 12 months		Reasoning
	Return	Risk	
Equities	**11%**	**11%**	Strong data from the US and improvement potential in the euro zone, assuming a weaker euro and lower energy costs. Support is continuing from further central bank stimulus measures in Europe, Japan and China.
Fixed income	**3%**	**4%**	Low inflation and weaker growth signals in some places will give central banks reasons to keep key interest rates low for another while. Government bond yields will probably remain at record lows for a while longer. However, there is little room for even lower yields. Wider yield spreads against government bonds have increased short-term potential for investment grade (IG) and high yield (HY) bonds. HY yields may fall somewhat in the short-term, with bond prices rising as a result. However rising yields in the coming year remain a risk, making short durations appear the most attractive.
- Government bonds	-1,1%	4,2%	
- Investment grade corporate bonds	1,1%	2,4%	
- High yield corporate bonds	5,0%	3,8%	
Hedge funds	**3%**	**4%**	A stable trend will mean lower correlations with other asset classes, benefiting many hedge fund strategies.
Real estate	**5%**	**12%**	Low interest rates along with strong macro data, especially from the US, will continue to benefit this asset class.
Private equity (PE)	**14%**	**14%**	Growth and recovery in the US economy, along with expanded monetary stimulus measures in Europe and Japan, will provide a good foundation for continued strong activity in this asset class.
Commodities	**3%**	**12%**	After about a 30% oil price decline since early summer, we believe that next year's prices will be somewhat higher than today's, although they may first become lower before they go higher. We also expect higher prices for industrial metals during 2015, as a result of supply shortages of both nickel and aluminum and future shortages in the copper market. The decline in gold prices will probably continue, while agricultural commodity prices have stopped falling.
Currencies	**N/A**	**N/A**	The US dollar is in a strong trend, and differences in monetary policy between the US and the rest of the world justify continued dollar appreciation. Our forecast (12 months ahead) for the most central currency pair EUR/USD is 1,17.

View on regions

Region	Outlook	Reasoning
Globally	1 2 3 4 **5** 6 7	Global equities will be supported by recent improvements in macroeconomic data and higher growth, which will eventually have an impact on corporate earnings. Higher P/E ratios and share prices will require upward revisions in earnings forecasts and better earnings growth, which we are now seeing signs of in quarterly reports. A stable growth phase for equities is our main scenario.
United States	1 2 3 4 5 **6** 7	The US is leading the economic recovery. Macro data continue to improve and companies are in very good shape, with strong balance sheets and high margins. Equity valuations are high, but good earnings growth will justify share price upturns.
Europe	1 2 3 4 5 **6** 7	After this autumn's decline in European stock markets, we see potential for upside surprises. Macro data are mixed, but with stable tendencies, and fiscal policy is supportive. Equity valuations and earnings growth look attractive. Companies are cost-effective and competitive, and they will benefit from weaker currencies.
Asia/Emerging markets	1 2 3 **4** 5 6 7	Increased global growth will benefit Asia and emerging markets. Low equity valuations and good earnings growth are attractive, and we have a positive long-term view. Mixed macroeconomic statistics and weak interest from investors are making us a bit cautious in the short term. We prefer Asia and China to Russia and Latin America.
Japan	1 2 3 **4** 5 6 7	Macro data are improving and fiscal policy is supportive. A weaker yen has benefited exports. Valuations have come down to reasonable levels, but high earnings growth will slow next year. Stock market performance will depend on whether official stimulus measures can be fully implemented or not.

*The view scale from 1 to 7 shows how we currently view a region. Level 4 is a neutral, 1 is very negative and 7 is very positive stance. The levels are changed continuously based on our tactical market view and may thus diverge from our long-term strategic view of a region.

Source: SEB Investment Outlook, December 2014

Terminology explanation

Terminology used	Explanation
Correlation (correlation coefficient)	In the world of finance, a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management. Correlation is computed into what is known as the correlation coefficient, which ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random. In real life, perfectly correlated securities are rare, rather you will find securities with some degree of correlation.
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.
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.
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.
Hedge funds' strategies	Event-driven strategy – a strategy, adopted by hedge fund managers, that attempts to take advantage of events such as mergers, acquisitions and restructurings that can result in the short-term mispricing of a company's stock. Trend-following strategy (i.e. commodity trading advisers, CTA) – investment strategy based on the technical analysis of market prices, rather than on the fundamental strengths of the companies. In financial markets, traders and investors using a trend following strategy believe that prices tend to move upwards or downwards over time. They try and take advantage of these market trends by observing the current direction and using this to decide whether to buy or sell.
Household (private) consumption	Transaction of the national account's use of income account representing consumer spending. It consists of the expenditure incurred by resident households on individual consumption goods and services, including those sold at prices that are not economically significant.
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".
P/E ratio	A valuation ratio of a company's current share price compared to its per-share earnings. For example, if a company is currently trading at 43 EUR a share and earnings over the last 12 months were 1,95 EUR per share, the P/E ratio for the stock would be 22,05 (43/1,95). In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. It is usually more useful to compare the P/E ratios of one company to other companies in the same industry, to the market in general or against the company's own historical P/E.
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.
SEB House View	Economic forecasts prepared by economists, strategists and analysts of SEB bank.
SEB Investment Outlook	A public release prepared by SEB economists, strategists and analysts. Investment Outlook gives readers an in-depth look at the investment climate and the prospects for seven asset classes. It also provides advice about current risks and opportunities in the art of investing. The report can be read in its entirety at www.sebgroup.com
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.