Investment Outlook

Markets waiting for earnings confirmation

INVESTMENT OUTLOOK SUMMARY

March 2014

Brief world economic outlook

The international economic upturn appears increasingly stable. Developed markets (DM) have scored various macroeconomic successes this winter, supported by continued ultra stimulative monetary policies and fading fiscal policy headwinds. Meanwhile the emerging market (EM) sphere has suffered from clear problems. EM countries with a combination of high inflation, large current account deficits and political instability are especially hard hit. But assuming that the global economic upturn continues, the risks of an EM financial crisis like the Asian one in 1997 seem small. Lower than expected global growth and US Federal Reserve's (Fed) ongoing "tapering" of its bond purchases are the main risks for EM countries.

The world economy is accelerating. We expect global GDP growth of nearly 4% this year and 4% in 2015, after just over 3% in 2013. The EM sphere will grow the fastest, by about 5% annually in 2014-2015, but the growth gap to the DM sphere will narrow, with developed market GDP set to rise by nearly 2,5% in 2014 and over 2,5% in 2015, compared to only 1,3% in 2013.

US economy is continuing to improve

Growing household wealth thanks to rising home and share prices, along with a gradually improving labor market, signals higher US consumption ahead. We expect US GDP growth to accelerate from less than 2% last year to nearly 3,5% this year and more than 3,5% in 2015. Inflation will remain low but tend to creep higher. The labor market will gradually heat up – unemployment may drop to 6% as early as this year – causing business payroll costs to rise a bit faster. This indicates that the Fed will continue to taper its monthly bond purchases at the current pace of USD 10 billion per policy meeting and that the first key interest rate hike will occur in the summer of 2015.

Euro zone bright spots, but also worries

The euro zone has climbed out of its recession. After falling by nearly 0,5% last year, we predict that GDP will grow by 1% this year and more than 1,5% in 2015. Overall fiscal policy will be largely growth-neutral in 2014-2015. The actions of the European Central Bank (ECB), along with narrowing fiscal imbalances and improved competitiveness, have greatly lowered sovereign bond yields in countries like Ireland, Spain and Portugal, but southern Europe has not left the crisis entirely behind, so there is some remaining risk of market disappointments. Notable among euro zone worries are record-high unemployment and a banking system that is not yet working normally. The latter, together with worries about deflation (generally falling prices), indicates that the ECB will soon offer banks another round of long-term LTRO loans and will launch a bond purchasing programme. Meanwhile the ECB's key interest rate will remain at 0,25% for a very long period.

Uncertainty about Japan will increase

Because of unusually stimulative economic policies, Japan's economy and stock market strengthened greatly in 2013, but now fiscal policy will tighten (including a consumption tax hike), challenging economic growth. After growing by more than 1,5% last year, we believe GDP will increase by less than 1,5% this year and next, while tax hikes and the Bank of Japan's expansionary policies will push up inflation, especially this year. In the long term, structural reforms (the "third arrow" of "Abenomics") will pave the way to better growth and rising salaries will help keep inflation at about 2%. But there is a risk that structural reforms will fail and that companies will remain reluctant to give their employees higher pay.

EM: faster growth in Asia, economic trouble spots in Latin America

Growth in Asian EM countries will accelerate in 2014 and 2015, partly because of exports to the US and Europe, but intraregional trade is also taking off. Export-led growth will mainly benefit small open economies such as Singapore and Taiwan, while the situation of commodity-exporting economies like Indonesia and Malaysia will be less positive. In China, growth will decelerate cautiously in 2014-2015, mainly due to reform efforts including a tightening of credit expansion. We predict GDP growth of less than 7,5% this year and 7% in 2015, after more than 7,5% last year. Argentina and Brazil have experienced especially great economic and financial turbulence in the past six months. Argentina's central bank recently gave up defending the peso. The major depreciation that followed will add further to already high inflation pressure. In Brazil, the weak real along with rapid price increases have persuaded the central bank to continue its key interest rate hiking policy. In both countries, the economic outlook appears dim, at least in the short term. Another major economy in the region characterised by better macroeconomic figures is Mexico. We forecast overall Latin American GDP growth of more than 2,5% this year (the same pace as in 2013) and more than 3% in 2015.

World stock markets need more evidence in earnings growth

The world's macroeconomic experts increasingly concur that global economic prospects are looking better and better. But does higher GDP growth automatically fuel continued stock market rallies? Both yes and no. The stock market is a leading indicator. In other words, it climbs on hopes of a brighter future – and once we look closely at the evidence and note that growth is actually taking off, the stock market has often already celebrated some of this victory in advance. Meanwhile, greater optimism obviously provides opportunities for higher earnings, which are the most efficient stock market fuel. Last year, equities rose mainly on hopes of higher earnings. Now it is time to show the evidence. We will need to see accelerating earnings growth for stock markets to reach even greater heights.

Themes

Are deflation and inflation worries justified?

Simultaneous worries about deflation and inflation have recently arisen. Inflation is often more short-lived and dramatic, whereas deflation can be a long drawn-out big trouble. There now seems to be a greater risk of deflation, but the chances of avoiding general deflation are good. Both inflation and deflation create uncertainty about the future. In a society with inflation, there is incentive to consume quickly, preferably with borrowed funds. In a deflationary society, it is rational to postpone consumption since goods/services will be cheaper later on. Expectations of falling prices bring high saving/low consumption, which – due to excess supply – makes prices fall more. That further weakens consumer demand, which leads to even greater downward price pressure and so on. This vicious circle is also fed by a growing number of bankruptcies and growing credit losses in the banking system. Deflation currently seems more frightening in DM but not equally in all regions. Highest deflation risk is in the euro zone, but if the ECB launches new monetary stimulus measures then deflation can probably be avoided. In the US there is far less deflation risk than in Europe – especially since the economy looks set to strengthen going forward, and some economic sectors are actually seeing wage hikes. In Japan the government's economic strategy, known as "Abenomics", helped country to pull out from deflation but this strategy needs to be working going forward. To sum up, there is no deflation in sight over the next two years, but keep in mind that deflation/inflation risks may be unpredictable.

World energy map being redrawn

During last few years, new extraction methods have made it possible to access enormous oil and gas deposits that were previously commercially unreachable. The world energy map is being redrawn, and this will affect many areas. Well over 90% of world oil production today takes place from conventional resources/reserves. This refers to oil and gas extracted from geological formed reservoirs and it allows oil and gas to easily flow into the borehole. But new extraction methods that combine "fracking" (hydraulic fracturing) and horizontal drilling have freed up enormous resources and made the extraction of unconventional reserves in recent years possible. There are a lot of examples in US, Canada, Venezuela. With conventional resources the market has generally viewed USD 110 per barrel of Brent crude as a kind of floor for future oil prices, but our assessment is that this figure may instead become a ceiling. The potential of unconventional resources is very large. In Australia, South America, Russia, South Africa, China and Europe, both technical and political developments are under way that will allow the profitable extraction of unconventional resources. What economic consequences will the new oil and gas deposits have? It is a little too early to predict exactly what the consequences will be, but we are convinced of one thing: this is just the beginning of a very big change. In 10 years, perhaps the US will get by almost without oil imports with a major impact on the US economy and current account balance. We can assume that increased independence will also lead to a reduced US interest in the Middle East (with opportunities to cut back the military budget). Low prices and stable energy supplies should have positive consequences for consumers and for growth in most parts of the world. Energy-intensive companies in particular will benefit. Our main message is that the energy map is being redrawn and that this will affect many areas. Our advice is to take these changes seriously. Those who are able to respond proactively to future developments and are aware of the changes that are taking place will be more successful than those who are passively watching (and perhaps even denying what is happening). The rapid development of global unconventional oil and gas extraction will bring major changes, whether we like it or not.

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 investment trust (REIT) 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	**9%**	**13%**	We are sticking to our positive strategic view of equities. The global economic recovery will support it, but valuations have reached levels that are causing us to adopt a cautious short-term stance. Earnings estimates continue to be revised downward and despite relatively good signals from purchasing managers, corporate earnings will take time to materialise. Europe is our first choice among equity markets, with Asia a close second. Continued market gains will require better earnings, and year-end financial statements did not give us the desired results.
Fixed income	**2,8%**	**5%**	Corporate bonds in the high yield segment still seem to be the most attractive assets in the fixed income market, thanks to such factors as good corporate health, central bank stimulus policies and the prospect of higher risk appetite. Risk/reward ratio keeps becoming less attractive also in investment grade corporate bonds. Rising yields on government bonds in developed markets, with adverse effects on bond prices, make these unattractive for fixed income investors.
- Government bonds	0,3%	4,9%	
- Investment grade corporate bonds	1,1%	2,5%	
- High yield corporate bonds	4.6%	5,2%	
Hedge funds	**4%**	**4%**	During 2013, markets continued to “normalise”, with decreased impact from the actions of politicians and more focus on company fundamentals. Both Equity Long/Short and Relative Value managers with a fundamental approach have had good returns over the past 12 months, and we expect that they will continue to deliver. The climate for Event Driven strategies also remains favourable.
Real estate	**5%**	**12%**	Expansionary monetary policies and signs of improved economic growth in Europe and the US should benefit real estate, but the shortage of investment alternatives and greater sensitivity to interest rates are still reasons to be cautious about this asset class.
Private equity (PE)	**10%**	**16%**	The outlook for the PE asset class will be positive over the next few years. Continued improvements in economic fundamentals – especially in Europe and the US – along with the continuing search for alternative sources of returns, will provide further potential. However, if risk appetite fades, volatility in PE asset class would increase more than in the broader stock market.
Commodities	**-4%**	**15%**	The risks have increased and we are not expecting any returns in the next 12 months. The industrial metals market is balanced, oil prices are expected to be about the same a year from now and we expect gold prices to continue falling. For agricultural commodities generally, we expect rising inventories and falling prices for another while. Weather phenomena such as La Niña and El Niño obviously have the potential to change this picture.
Currencies	**N/A**	**N/A**	In 2013, economic growth improved in the US and UK, while the euro zone left its recession behind. This benefited the USD, GBP and EUR. The only major currency to drop significantly in value last year was the JPY, which was weighed down by extremely stimulative economic policy in Japan (“Abenomics”). Our forecasts (12 months ahead) for the most central currency pair – EUR/USD 1,28 (-6,6%).

Tactical view on regions

Region	**View***	**Reasoning**
Globally	1 2 3 4 **5** 6 7	In the slightly longer term, global equities will enjoy continued support from global economic growth. Achieving higher P/E ratios and share prices will require upward revisions in earnings forecasts and a better earnings trend. Share valuations are higher than the historical average and the market is thus more sensitive to negative news.
United States	1 2 **3** 4 5 6 7	Relatively stable macro data as well as better earnings growth and company reports have already led to a strong market that is trading at record levels. Valuations are stretched, which limits potential.
Europe	1 2 3 4 **5** 6 7	Europe is more positive than neutral, since macro data are continuously improving and valuations and earnings growth look attractive compared to the US and emerging markets. The ECB and fiscal policies are supportive, while companies are cost-effective and competitive.
Asia/Emerging markets	1 2 3 **4** 5 6 7	Asia continues to be a growth investment for the long term, with some caution at this stage. Unstable forecasts mean that we are somewhat neutral about this region. Choose less developed countries in Asia with continued high growth potential. Avoid pure commodity exporters.
Japan	1 2 3 **4** 5 6 7	The government’s stimulus package has triggered a stock market rally and a fall in the currency. The impact of new policies is now beginning to show up in macro data. High earnings forecasts have been revised upward, but from low levels. Stimulus measures are having a positive effect on Asia as a whole.

*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, March 2014

Terminology explanation

Terminology used	Explanation
"Abenomics"	"Abenomics" is a set of policy measures (launched by Japan's Prime Minister Shinzo Abe) meant to resolve Japan's macroeconomic problems. It consists of monetary policy, fiscal policy, and economic growth strategies to encourage private investment.
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.
Domestic demand	Total purchases of goods and services, regardless of origin, by country's consumers, businesses, and governments during a given period. Domestic demand equals gross domestic product minus net exports.
El Niño, La Niña weather patterns	These are the titles of weather patterns of anomalously warm or cold ocean water temperature that periodically develops off the western coast of South America and can cause climatic changes across the Pacific Ocean. The two variations are coupled: the warm oceanic phase, El Niño, accompanies high air surface pressure in the western Pacific, while the cold phase, La Niña, accompanies low air surface pressure in the western Pacific.
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	Market neutral strategy – a strategy by hedge fund managers that seeks to profit from both increasing and decreasing prices in a single and numerous markets. 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. Relative value strategy is a catchall for a variety of different strategies used with a broad array of securities. The underlying concept is that a hedge fund manager is purchasing a security that is expected to appreciate, while simultaneously selling short a related security that is expected to depreciate.
Household (private) consumption	Private consumption is defined as the value of the consumption goods and services acquired and consumed by households.
LTRO (long-term refinancing operations)	This is a cheap loan scheme (lending money at a very low interest rate) for European banks that were announced by the European Central Bank 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.
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.
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
US Federal Reserve's "tapering"	This is an expression of the US Federal Reserve Bank's (Central Bank) decision to reduce the volume of bond purchases (quantitative easing). Quantitative easing is a central bank's monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.