PRIVATE BANKING • INVESTMENT STRATEGY

Investment Outlook

March 2015

SEB

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Large currency movements and new stimulus measures broaden the upturn

In recent years, the economy and central bank of the United States have acted as the linchpin of the global economy. The recovery is visible in the US labour and real estate markets and through the strength of financial asset markets.

Falling commodity prices, for example via petrol (gasoline) prices, have created additional room for consumer spending – the US economy is 70 per cent consumption-driven. Overall, the economy is now in such good shape that it is difficult to argue that the Federal Reserve (Fed) should not begin normalising US monetary policy via a period of key interest rate hikes. SEB's assessment is that the first such hike will occur in September.

Conditions in the rest of the world are markedly different from the American situation. In Europe and Japan, extremely low and in many cases negative key interest rates prevail, combined with massive liquidity injections. The European Central Bank (ECB) has launched an asset purchase programme, equivalent to about 10 per cent of total euro zone GDP. The Bank of Japan and various smaller central banks are also continuing to stimulate their economies through interest rate cuts and liquidity injections.

The effect of the above-described developments has been to strengthen the US dollar significantly. This is a very desirable effect, since it implies a stabilisation of the economic system and a broader economic upturn. US economic strength is enabling the country to cope with a stronger currency while the rest of the world, led by Europe and Japan, receives extra help via sharply weaker currencies, record-low interest rates and low oil prices. This also applies to Sweden.

Because of gradually stronger global economic growth, combined with continued support from central banks, stock exchanges in Europe including Sweden are now clearly higher than when we published the last issue of *Investment Outlook* on December 2, 2014. The performance of US and Asian stock markets has been flatter in local currencies, but in Swedish currency terms the trend is clearly positive due to the weak krona. Interest rates have continued to fall, which has also helped asset managers to achieve returns. Yet the potential is limited, to say the least, since many European countries including Sweden now have government bond yields that are negative. Since the last *Investment Outlook,* companies have also published new quarterly reports. One of the more striking effects has been the impact of exchange rate shifts.

How does all of this affect our present market view? Despite sharply rising share prices, our attitude towards equities remains positive. This applies both to the Swedish and global stock market. However, we are sceptical towards commodity-producing companies, for which we expect a continued weak price component. In the case of fixed income investments, we continue to prefer corporate credit instruments to government bonds and are avoiding long maturities.

In this issue of *Investment Outlook*, we take a close look at the effects of large oil price movements. We also analyse the consequences of extremely low interest rates and bond yields: What happens when they approach zero or become negative?

In addition to these themes, we analyse asset classes and present our current portfolio management strategy. This issue includes a minor change of format: we are combining our commentaries on alternative asset classes such as hedge funds, real estate, commodities and private equity. We will comment on these asset classes as needed and not regularly in each publication.

Wishing you enjoyable reading,

FREDRIK ÖBERG
Chief Investment Officer

Equities still set the pace despite high valuations

A combination of accelerating economic growth and continued liquidity injections by the world's central banks will provide additional fuel to the stock market, despite clearly rising share prices. Higher valuations reduce potential and imply that volatility may end up at a higher level than we have been accustomed to in recent years.

Over the past few years, stock markets have been much stronger than the corporate earnings trend. Pricing of equities has thus undergone a gradual upward adjustment. Our global economic growth forecast for the next couple of years is 3-4 per cent annually and should result in yearly global earnings growth in the range of 5-10 per cent. Dividend yield is 2-4 per cent, depending on what stock exchange we evaluate – implying a total expected stock market return of about 7-10 percent. This should be compared to alternative investments in the bond market, which range from very low to negative yields in the government bond segment to expected returns of around 3-5 percent in the corporate segment.

We continue to prefer equities to bonds. Looking at bonds, we are overweighting corporate bonds in our portfolios at the expense of government bonds. Finally, we are supplementing our portfolios with alternative investments, largely consisting of hedge funds. The risks with this strategy are mainly connected to any disappointments about economic growth and, indirectly, about the ability of companies to generate rising earnings. In a longer-term perspective, the whole economic system is exposed to risks associated with rising interest rates. These effects nevertheless lie further in the future, although in the near term we may experience volatility connected to the US central bank's expected hike in its key interest rate. The situation in Greece may also generate market turbulence.

STRONG PRICE TREND DRIVING UP VALUATIONS IN WORLD STOCK MARKETS

Source: Bloomberg

The chart shows stock market index trends in three of the most important countries or groups of countries, plus the Nasdaq OMX Stockholm. This trend is mainly being driven by capital inflows, since alternative sources of returns are few in today's low interest rate/bond yield environment.

EXPECTED RISK AND RETURN

Our risk and return expectations are taken from the SEB House View. These expectations cover the next 12 months and are revised once a month, or more often if the market situation requires. These forecasts are as of February 25, 2015.

ASSET TYPE	TACTICAL EXPECTED RISK AND RETURN (YEARLY FIGURES)		INDEX/BASIS FOR CALCULATION
	RETURN	RISK	
EQUITIES			
Global	10.0 %	12.0 %	MSCI All Country World Index in local currencies.
Swedish	13.0 %	14.0 %	SIX Return Index in SEK.
FIXED INCOME			
Corporate bonds (IG)	0.5 %	2.5 %	IBOXX Investment Grade Index in USD.
Corporate bonds (HY)	4.0 %	4.0 %	IBOXX High Yield Index in USD.
EM debt	6.0 %	9.5 %	JP Morgan Emerging Market Bond Index in local currencies.
Government bonds	0 %	4.0 %	OMRX T-Bond Index.
Cash	-0.2 %	0.1 %	Equals assets with risk-free returns, measured as the OMRX T-Bill Index.
ALTERNATIVE INVESTMENTS			
Hedge funds	4.0 %	4.0 %	HFRX Global Hedge Fund Index in USD.
Commodities	N/A	N/A	
CURRENCIES	N/A	N/A	Not a separate asset class, but used as a source of returns in our asset management.

Source: SEB

MAIN STRATEGIES IN OUR PORTFOLIO MANAGEMENT

- **Currency shifts are helping strengthen and broaden the economic recovery**
  The United States remains the economic engine, but the rest of the world is being helped by record-low interest rates, favourable currency exchange rates and abundant liquidity from central banks. This should also increase the probability of a better earnings trend.

- **The liquidity factor remains positive**
  Although the US Federal Reserve is approaching the time when it should begin a period of key interest rate hikes, the overall signal or "net effect" of world central bank policies is clearly positive, due to ultra-low interest rates combined with large liquidity programmes.

- **The effects of the oil price slide vary, but it is benefiting global growth**
  Low oil prices have an immediate negative impact on oil-producing countries, but meanwhile have a more long-term positive effect on the rest of the world. The net outcome is clearly beneficial to economic growth.

- **Equities have the highest expected returns**
  Despite many years of upturns, equities have the highest expected returns. Corporate earnings should be able to climb by 5-10 per cent. In addition, dividends will be in the 2-4 per cent range. We prefer broad exposure, with US equities providing stability and a strong currency but higher than average valuations. Europe including Sweden is benefiting from weaker currencies, "lower" valuations and stronger expected earnings growth. Equities in Japan and the rest of Asia look reasonable.

- **Interest rates record-low for a while, then rising**
  Central banks and deflationary impulses will keep down interest rates and bond yields for another while. After that, they should begin an upward path. This makes us unwilling to hold long maturities in our fixed income portfolios, and we recommend keeping a low share of total holdings in government bonds.

- **Volatility at a higher level**
  The market has become choppier. We thus see a continued need for hedge funds and other alternative investments as a complement and risk diversification. US dollar exposure in global equities likewise generally serves as a good risk-smoothing tactic. We also believe that the dollar will continue to climb.

- **Risks**
  One risk that we regard as low, but real, is that our view of economic growth may be too optimistic. This would lead to earnings disappointments, which in turn would result in valuation problems in stock markets. Greece remains a potential risk, although we regard it as manageable. Geopolitical risks are always on the map. Finally, market rallies open the way for profit-taking and downward corrections. Another result of market upturns is that there are few obviously "cheap" assets.

EQUITIES	WEIGHT	REASONING
Swedish	1 2 3 4 **5** 6 7	The weak krona, combined with more robust global growth and a stable domestic situation, will provide strength. In international terms, dividend yields are high. Valuations have climbed in recent years. Further ahead, there are clear risks connected to the real estate market and future higher interest rates in Sweden.
Global	1 2 3 4 **5** 6 7	Accelerating economic growth and continued stimulus measures will boost the potential for higher earnings. A broader upturn will increase opportunities for cyclical industries. Valuations have climbed, yet equities offer better value for money than fixed income investments.
FIXED INCOME	**WEIGHT**	**REASONING**
Government bonds	**1** 2 3 4 5 6 7	Because of very low government bond yields, portions of the bond market are unattractive. Stronger economic conditions may lead to gradually rising yields over the new few years.
Corporate bonds, investment grade (IG)	1 **2** 3 4 5 6 7	Low yields provide a little potential, but this asset type may work well in a portfolio that includes other higher-risk assets.
Corporate bonds, high yield (HY)	1 2 3 **4** 5 6 7	Yields of around 3-4 per cent stand out in the fixed income world, but as a consequence there is also clearly higher risk than with IG bonds, for example. HY bonds will benefit from rising growth and market liquidity, which boost risk appetite. Yield spreads should thus narrow or remain stable.
Emerging market (EM) debt	1 2 3 **4** 5 6 7	Yields of around 6 per cent provide reasonable compensation for the risks connected to this asset type.
ALTERNATIVE INVESTMENTS	**WEIGHT**	**REASONING**
Hedge funds	1 2 3 **4** 5 6 7	Clear trends combined with lower correlations between and within asset classes suggest investing in hedge funds.
Commodities	1 2 **3** 4 5 6 7	Gradually falling demand from China and elsewhere, combined with capacity increases, has resulted in sharply falling commodity prices. The price picture stabilised somewhat early in 2015. In a longer-term perspective, this asset class is attractive if inflation rises along with commodity prices.
CURRENCIES		**12-MONTH FORECAST (CHANGE IN BRACKETS) AS OF FEB 23, 2015**
EUR/USD	N/A	1.10 (-8.0 %)
EUR/SEK	N/A	9.30 (-2.3 %)
USD/SEK	N/A	8.90 (+6.2 %)

Source: SEB

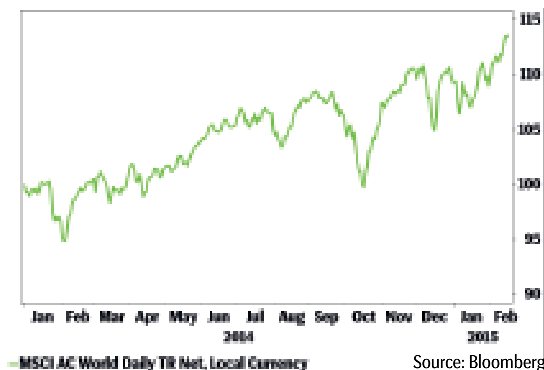
** "Weight" shows how we currently view the asset as part of a portfolio. Level 4 is a neutral stance. These weights are changed continuously, based on our tactical market view, and may thus diverge from our long-term strategic view of an asset. At the customer level, portfolios are tailored to individual needs.*

SWEDISH AND GLOBAL EQUITIES ARE OVERWEIGHTED IN OUR PORTFOLIOS

During a period of stock market turmoil in October 2014, we boosted the percentage of equities in our portfolios on the expectation that growth would accelerate, that central banks would continue to stimulate their economies and that equities had the most favourable valuations of the various asset classes. We are sticking to this view. Our portfolios combine an overweighting of Swedish and global equities with an underweighting of fixed income and alternative investments. As for fixed income investments, we hold a low percentage of government bonds. In alternative investments, which are dominated by hedge funds, we have broad exposure to many different strategies, but we avoid funds with high stock market risk.

EQUITIES

After several years of very strong upturns, driven by a combination of low valuations, rising earnings and plenty of market liquidity, equities are now fully valued in a historical perspective. During 2015 we expect better corporate earnings growth than in the preceding two years as well as an upturn not dominated by defensive sectors, technology and financials. The expected acceleration in economic growth and broader global demand suggest that the losers during previous years – cyclical companies – may assert themselves better. Currency rate changes also indicate that earlier American dominance will fade. US equities are more expensive than elsewhere in the world. One positive factor for US equities is expected USD appreciation, which will boost returns from the perspective of European investors. We thus prefer broad global exposure and also view the Swedish stock market favourably, although its short-term performance may have been a bit too strong.



Source: Bloomberg

The chart shows global stock market performance from the beginning of 2014 until February 23, 2015.

FIXED INCOME

Low inflation pressure and the actions of central banks – with key interest rates at around zero and large stimulative government bond purchasing programmes – have resulted in an odd situation, with negative sovereign bond yields in much of the world. Returns have been fantastic, but future potential is reduced. As a result, we must lower our return requirements and look for other exposures. In the fixed income world, this means increasing exposure to corporate credit instruments and measuring the resulting increase in risk against alternative investments in other asset categories. We have a small percentage of government bonds in our portfolios and mainly combine different types of corporate credits depending on customers' specific risk profiles. Due to extremely low yields, we are also cautious about maintaining long maturities, since this exposes us to potentially negative returns if yields begin to climb.

Source: Bloomberg/Macrobond

The chart shows the performance of different corporate bond segments since January 1, 2014. Government bonds have performed best.

ALTERNATIVE INVESTMENTS – HEDGE FUNDS

Within the alternative investment category, we mainly use hedge funds. Over time, they have a risk profile somewhere between equities and fixed income investments. Individual hedge funds may, in themselves, have a completely different risk profile. This is why we devote extensive effort to analysing funds and trying to find suitable portfolio combinations. Our ambition is that our investments in this category should create stability in portfolios and preferably demonstrate low correlation with stock market performance.

Source: Bloomberg

Global hedge funds began 2015 strongly.

Global opportunities outweigh threats

- *Gradual economic acceleration in 2014-2016*
- *Upside factors like lower oil prices and monetary stimulus are more than offsetting...*
- *... downside factors such as geopolitical worries and deflation risks*

Global economic indicators have diverged since last summer. The American economy has strengthened. Japan has dipped into a new recession. British economic growth has remained healthy. After an obvious slump, the euro zone has regained some of its dynamism since late in 2014. Growth in the emerging market (EM) sphere as a whole has weakened, but here too the pattern has varied. China's economy has moved cautiously towards slower growth rates, while India has delivered upside surprises. In Brazil, economic indicators have pointed the wrong way, and Russia is sliding into a deep recession.

Looking ahead, global conditions will change in both positive and negative ways. The oil price decline, which has created some short-term concerns and problems, will benefit future world economic growth. The same is true of monetary policy stimulus. Although the US Federal Reserve (Fed) and the Bank of England (BoE) will take steps towards tightening monetary policy in the coming year, this will be far outweighed by expanded stimulus from the European Central Bank (ECB), Bank of Japan (BoJ) and People's Bank of China (PboC), as well as from some smaller central banks such as Sweden's Riksbank.

On the negative and worrisome – but less weighty – side of the scale are geopolitical troubles, such as the Ukraine-Russia conflict (though a ceasefire agreement for eastern Ukraine was signed in mid-February) and IS/Iraq/Syria. The decline in oil prices also means that the risk of deflation (generally falling prices) has become more widespread in the world.

Geopolitical worries and the uncertain consequences of exceptional central bank stimulus policies, including negative interest rates in parts of Europe, are the foremost risks to our main scenario. But the unexpectedly positive growth impact of the oil price decline, a surprisingly strong favourable effect from ECB policies and greater-than-anticipated help from the US economy represent opportunities.

Elements in place for high US growth

The halving of oil prices is especially beneficial to US household purchasing power, which is also helped by an increasingly strong labour market that is giving Americans better incomes. Growing wealth, due to the stock market upturn and rising home prices, is also providing underlying financial stability to households. Private consumption, which is equivalent to a full 70 per cent of gross domestic product (GDP), will thus probably be the strongest US growth engine in 2015-2016.

We expect US GDP to expand by 3.5 per cent this year and 3.2 per cent in 2016. Despite high growth, consumer prices will fall slightly this year due to cheaper oil, a stronger dollar and plenty of still-idle production resources in the business sector. In light of this, we predict that the Fed will hold off on its first key interest rate hike until September 2015.

Euro zone outlook a bit brighter

The euro zone growth outlook has improved, as shown by such indicators as current purchasing managers' indices. One reason is that the currency union, as a large net importer of oil, benefits especially when oil becomes much cheaper. Another is the surprisingly powerful stimulus package that the ECB unveiled in January. By weakening the euro and having a positive effect on bank lending, this package has the potential to help lift growth and reduce deflation risks. Price increases may eventually move very cautiously towards the ECB's target, which is inflation a bit above 1.5 per cent.

But we still foresee various problems and risks. Debt remains high in many parts of the euro zone. The political will to increase economic integration has weakened, and populist parties have made big gains. Trade sanctions and recession in Russia are hurting both exports and capital spending plans in the euro zone. The German economy is improving and the Spanish recovery continues at a rapid pace, while the French and Italian economies are lagging. For the euro zone as a whole, we forecast GDP growth of 1.2 per cent in 2015 and 1.7 per cent in 2016.

British growth second only to US

With GDP expected to increase by 2.8 per cent this year and 2.5 per cent in 2016, the United Kingdom will show the second fastest growth in the G7 (the seven wealthiest major developed countries) after the US. Very low inflation and a continued decline in unemployment promise strong British household spending. The latest business sentiment surveys indicate that companies have started 2015 nicely. Low inflation indicates that the BoE should not be in a hurry to start raising

its key interest rate before early 2016. Political uncertainty will probably increase in the run-up and aftermath of the May 7 parliamentary election. Neither the Tories (Conservatives) nor Labour appear able to win their own majority, so a new coalition government is likely. One joker in the pack is the EU-sceptical UK Independence Party (UKIP), which is gaining more voter support. Despite political uncertainty, there is reason for optimism about British economic potential.

Better growth in the Nordic countries

The Nordic economies have recently faced various challenges. The Russian crisis has had a sizeable negative impact on the Finnish economy. The Danish krone, which has been pegged to the euro (and before that the D-mark) for more than 30 years, has been subjected to speculation that it will follow the example of the Swiss franc – cutting ties with the euro, then climbing sharply in value. Sweden has experienced a bit of economic policy drama because of its government crisis late in 2014. And the Norwegian economy has been pulled down by plunging oil prices.

Yet all four countries have the potential to show better growth in 2015-2016 than last year. Positive driving forces include slightly improved economic conditions in the euro zone and highly stimulative monetary policies in the four countries themselves. Especially in Sweden and Norway, weaker and thus more competitive currencies may provide a helping hand in the short term. We expect Nordic GDP to grow by 1.9 per cent this year and by 2.2 per cent in 2016.

Japan's economy not good, but less bad

Last year Japan entered its fourth recession in six years, with the consumption tax hike in April 2014 as one important cause. But after more or less stagnant GDP last year, we foresee 1.1 per cent growth in both 2015 and 2016. Underlying this less bad outlook will be higher exports to the rapidly growing US economy along with a weaker Japanese yen and further government stimulus measures, especially as part of monetary policy. Being a large net importer of oil, Japan is also benefiting greatly from the oil price decline.

During some periods of 2014, Japanese inflation rose – thanks to higher import prices and the consumption tax hike – but lately it has quickly fallen again, partly due to lower energy prices. We predict that consumer prices will climb by 1.0 per cent this year and 0.7 per cent in 2016, thus still well below the BoJ's 2 per cent target in both years.

The first and second "arrows" in Prime Minister Shinzo Abe's "Abenomics" strategy – monetary and fiscal stimulus measures, respectively – have helped sustain Japanese growth and will continue to do so, but there is still great uncertainty about how much the third arrow, structural reforms, will contribute. The government has, however, taken steps to boost the share of women in the labour market and make it easier to recruit labour from abroad.

GROWING UPSIDE SURPRISES IN EURO ZONE ECONOMIC STATISTICS

Source Macrobond

During the spring and summer of 2014, most euro zone economic data consisted of downside surprises (negative index figures). Late in the year these surprises became fewer, and in 2015 upside surprises (positive index figures) have predominated to a growing extent. Among the statistics underlying these surprise index figures have been purchasing managers' indices in the euro zone.

Accelerating growth in emerging Asia

We expect most Asian EM countries to grow faster in 2015-2016. Most are net energy importers and therefore benefit from the oil price decline, which will also contribute greatly to lower inflation. Central banks in the region can thus stick to their loose monetary policies. In some countries – including India, South Korea and Thailand – further key rate cuts are likely.

Despite solid stimulus from the US and interest rate cuts in various countries, the acceleration in emerging Asian growth will be relatively modest. The reason is the slowdown in China, where GDP growth is expected to fall from 7.4 per cent in 2014 to 7.0 per cent in 2015 and 6.7 per cent in 2016. This slower rate of expansion is natural, since the economy is gradually transitioning from being largely led by exports and capital spending, to being driven more and more by private consumption. Productivity, and thus growth, is far higher in manufacturing than in services.

The prospect of further key interest rate cuts in India this year should be viewed in the light of markedly lower inflation. Prime Minister Narendra Modi's government has also achieved some progress in its reform policies, which will benefit growth. We forecast GDP growth of 7.3 per cent this year and 7.6 per cent in 2016, after last year's 7.0 per cent.

Latin America has lost growth dynamic

After growth figures of nearly 3 per cent both in 2012 and 2013, Latin America lost much of its economic growth dynamic and achieved a GDP increase of only 1 per cent in 2014. Meanwhile inflation has risen sharply and twin deficits – in budgets and current accounts – have swelled. The largest economy, Brazil, stagnated last year. Despite various reforms initiated by President Dilma Rousseff, much more reform work is required before growth will take off in earnest. Argentina is struggling with even bigger growth and inflation problems than Brazil. Among the better-off economies in the region are Mexico and Chile. We expect overall Latin American GDP to grow by 1 per cent this year and 2.5 per cent in 2016.

Widely divergent outlook in Eastern Europe

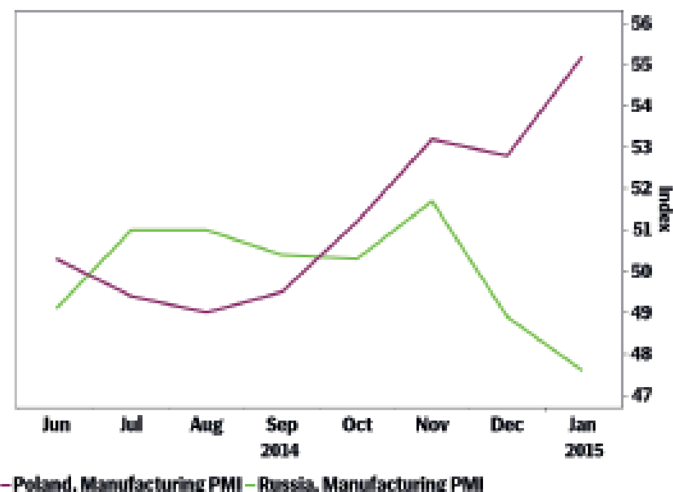
Thanks to good household demand, growth in Central Europe and south-eastern portions of Eastern Europe has not been especially hard hit by the Ukraine-Russia crisis and falling Russian demand. Central Europe's exports to Russia are also relatively small, while the euro zone and especially Germany are far more important markets. But in countries like Poland and Hungary, private consumption growth will slow because many mortgage loans are CHF-denominated and the Swiss franc's appreciation has made housing more expensive. Meanwhile employment is rising, however, and interest rates as well as inflation remain low. Cheaper oil will also help sustain purchasing power.

The situation and outlook are far worse in Russia, which has fallen into a deep recession. After the rouble's massive slide, an inflation shock dealt a powerful blow to household purchasing power. Despite these major strains, Russia will probably avoid a fiscal crisis since it has financial buffers. Meanwhile the Ukrainian economy is close to collapse. Rapidly falling GDP both in 2014 and 2015, along with rising military expenditures, has led to soaring budget deficits. But in mid-February, new loans from the International Monetary Fund brought a ray of hope.

The three Baltic countries faced greater challenges this winter due to Russia's deepening crisis, but this was offset largely by slightly better economic prospects in the euro zone. Meanwhile lower oil prices are adding extra purchasing power to households, which are acting as the main growth engine in the Baltics, but capital spending remains uncertain.

Gradually higher global growth

SEB forecasts higher world economic growth. After last year's 3.5 per cent GDP increase, global growth will be 3.7 per cent this year and 3.9 per cent in 2016. EM sphere growth will slow to 4.4 per cent this year and speed up to 5.0 per cent in 2016. Growth in developed market (DM) countries will accelerate to 2.6 per cent this year and maintain that pace in 2016.



Source: Macrobond

POLISH MANUFACTURERS MORE OPTIMISTIC, THEIR RUSSIAN COUNTERPARTS GLOOMIER

In many areas, economic curves are pointing downward in Russia but upward in Central Europe. One example is the purchasing managers in Russia's manufacturing sector, who have become increasingly pessimistic this winter compared to their colleagues in Poland, who are signalling an acceleration in manufacturing activity.

Lack of alternatives forces greater risk-taking

- **Capitulation to flood of new money**
  A lack of alternatives is forcing investors to take risks, lifting the stock market. Yet expensive shares are more attractive than guaranteed losses on fixed income securities with negative yields.
- **Weak Swedish krona will fuel earnings**
  The weakening currency will rescue 2015 earnings in Sweden's manufacturing sector. Winners will outweigh losers by a wide margin – they are both larger and more numerous.
- **Highest market valuations in 10 years**
  Shares are expensive but not compared to the alternatives, and after a weak period in 2012 and 2013 listed companies' earnings have been on the rise.

THE STOCKHOLM EXCHANGE'S REMARKABLE REBOUND HAS DRIVEN UP VALUATIONS

Source: Bloomberg

No matter what valuation metric we use, the stock market is expensive from a historical perspective. We consider the latest rally to be a capitulation by investors to the flood of money now expected from the European Central Bank. The chart shows the performance of the benchmark OMX30 index over the past six months. The slump in October was followed by a quick, strong rebound since investors lack alternatives that can offer the desired returns.

Valuations are high in the Nordic stock markets, including the Nasdaq OMX Stockholm exchange, from a medium-term historical perspective. The price/equity (P/E) ratio in our 2015 earnings forecast for the Nordic countries as a whole, adjusted for "non-recurring items", is 16, almost 30 per cent higher than the average over the past ten years. Also worth noting is that the P/E ratio is already much higher than when equities last peaked in 2007, but still far from the dizzying peak of 27 recorded in 2000.

If we instead look at the Nasdaq OMX Stockholm, which is now the most expensive of the Nordic exchanges, and if we use reported earnings for 2014 (without adjustments for nonrecurring items), the P/E ratio for the entire stock exchange is 24, more than 50 per cent above the average for the past ten years.

However, it is reasonable to value corporate earnings somewhat higher than normal in periods when earnings are squeezed by a weak economy, which is why another good valuation metric is the price/book value ratio (P/BV). But even using this metric, equities today are more expensive than the average for the past ten years and at their highest since 2007.

If we only looked at market valuation from a historical perspective, a sell recommendation for the market as a whole would be inevitable, although some individual shares would obviously still be attractive. However, we believe that market valuation cannot be considered in complete isolation from other external factors.

Earnings growth and revisions

On the positive side, we see that earnings for Swedish listed companies, after a three-year falling trend, finally grew again in 2014. We also expect even higher earnings growth in 2015 and 2016. The weak krona in particular is giving a strong boost to earnings for Swedish companies, especially in manufacturing. A cheaper krona also means that the earnings these companies generate in their foreign subsidiaries are worth more in Swedish kronor and that exporters will improve their margins and enhance their competitiveness. The biggest winners are companies with large costs in Sweden and international revenues. Naturally, the stock market also includes companies that are losers because of the weaker krona, but they are fewer and in most cases relatively small.

To a large extent, the big winners due to a weaker krona are in the same sectors that were most severely affected by the weak global economy – industrials, forest products and commodities. In many cases, we have had to revise our 2015 earnings forecasts upward for a number of large industrials because of an even larger positive currency effect, despite further downward revisions in underlying forecasts. Although investors have interpreted fourth quarter earnings reports as positive and currency movements have bolstered earnings, so far this year we have been forced to revise earnings forecasts for 2015 downward by another 1.4 per cent for companies on the Stockholm exchange. In other Nordic countries, things look even worse, with total downward revisions of 3.8 per cent, driven by Norwegian companies with exposure to oil and gas.

Relatively high earnings-based valuations in the stock markets are not a phenomenon restricted to the Nordic countries; the situation is similar in most of the world. High P/E ratios are an international phenomenon; the exception is countries where investors fear sharp earnings declines or are sceptical about reported earnings, such as Russia and China. From this perspective, we see no reason to be more worried about valuations on the Stockholm exchange than in the global stock market

Risky chance of good returns or guaranteed loss?

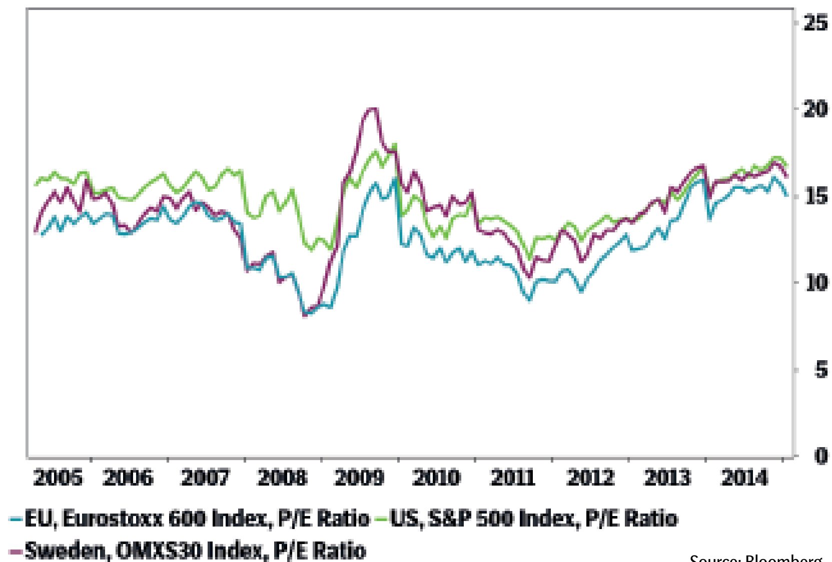
It is easy to complain about high share valuations, low-quality earnings growth (driven by a weak krona rather than demand growth) and the need to repeatedly revise earnings forecasts downward. But the stock market rally over the past 3-4 years has not been driven by strong earnings growth.

EARNINGS OF LISTED COMPANIES GROWING AGAIN

Source: SEB

The chart shows earnings growth of listed companies in percentage terms, calculated in euros and adjusted for nonrecurring items.

HIGHER SHARE VALUATIONS ARE AN INTERNATIONAL PHENOMENON



Source: Bloomberg

The chart shows rolling P/E ratios for the coming forecast year for large cap companies in Sweden (OMXS30), the US (S&P 500) and Europe (Eurostoxx 600). The decline in early 2015 is because the forecast year changed from 2014 to 2015.

Nor have we had any support from low valuations during the past two years. Share prices have been fuelled by liquidity, low interest rates and low bond yields. The unattractive alternatives have driven investors into the stock market, and today these alternatives are more unattractive than ever. Market yields on government securities are negative in many cases, which means that investors who buy them lock in a guaranteed loss if they hold them to maturity. Clearly, many shares are expensive today, which entails a high risk of losses going forward, but a lot of shares will probably generate a good return over a five-year horizon. For many investors, taking a chance like this in the stock market will seem far more attractive than locking in a guaranteed loss. With the ECB now launching massive bond purchases, totalling EUR 60 billion a month from March of this year to the autumn of 2016, even more capital will be forced to look for better alternatives in order to generate a return. We expect that significant amounts of new capital will find their way into the stock market and provide good support for higher share prices.

Acquisitions and buy-outs await

Because of today's extremely low interest rates and yields, acquisitions will generate a good return on investment; there are ample funds available, and many listed companies have strong balance sheets. Meanwhile, low demand growth means that companies have a limited need to invest in organic growth (for instance, build new production facilities). In addition, corporate executives and investors are frustrated with the low sales growth that companies can achieve without acquisitions. The combination of cheap, readily available funds, a lack of organic investment projects and weak organic sales growth suggests that we will see many corporate acquisitions in 2015.

This view is also backed by a survey that SEB conducted of 104 corporate executives who took part in our major investor conference in Copenhagen in January. There is great interest among Nordic listed companies in acquiring other companies, and many are disappointed with relatively weak demand growth.

Corporate transactions often help fuel share prices, both because listed companies are frequently acquired at a substantial premium over their market price and because acquisitions boost the earnings of the acquiring company. Investors whose companies are acquired often reinvest their capital in other shares.

A wave of money sweeping over Europe

To sum up, we can also explain our somewhat more positive stock market outlook, as well as the strong start to the trading year, as being somewhat of a capitulation to the wave of new capital that we expect to inundate Europe. For a long time, the stock market's trump card has been the unattractive alternatives, and this situation has only become more extreme over the past year. The additional liquidity that central banks will inject during 2015 and 2016 (perhaps even longer) will further entrench this situation. Stock market indices will be pushed even higher during the year, since equities are the alternative that seems the least overvalued.

However, we would like to remind investors that there are many sources of concern around the world, and the rally in 2015 will not follow a straight line. Instead we will most likely see a number of serious corrections along the way. Short-term falls in share prices of 5-10 per cent may well produce attractive buying opportunities, and large amounts of liquidity looking for returns suggest that rebounds may be rapid, as in October 2014.

Best alternative in a low yield environment

- **Central banks, oil prices and liquidity will benefit share performance**
  Forceful action by the world's central banks, cheaper energy and large liquidity flows will bolster stock exchanges going forward.
- **Europe has a relative advantage**
  Europe appears to be the most attractive alternative, since the European economy seems to have bottomed out and there is good potential for improvement. The US economy is strengthening, but valuations are high.

Global stock markets turned in a strong performance in 2014, with the benchmark MSCI AC World NR Index advancing almost 10 per cent in local currencies and as much as 27 per cent in Swedish kronor. India topped the stock market list, while other emerging market (EM) economies, such as Russia and Brazil, were at the bottom. European macroeconomic statistics created uncertainty during the year, reflected in a relatively weak performance for the region's stock exchanges. In contrast, US equities continued to outperform the global index despite high valuations, because stable economic data were persuasive to investors. Among the best performing sectors were pharmaceuticals and information technology, while commodities and energy did worse.

The year is off to a flying start

The financial world got off to an eventful start in 2015, with forceful monetary policy measures in the euro zone, a snap election in Greece and major movements in currencies and oil prices. Investors with assets in Swedish kronor (SEK) can be pleased with this flying start. The benchmark global index has risen about 10 per cent, with India, Russia and Hong Kong topping the list. The Nordic and other European exchanges have likewise done well. The US market is also up almost ten per cent in SEK, although returns are slightly lower in US dollars (USD). It is worth noting that global stock markets gained only 3 per cent in local currencies, with Russia standing out as the big winner (up 26 per cent).

Among news headlines early in the year, US corporate earnings reports for 2014 exceeded expectations. Overall, earnings per share grew 6 per cent compared to 2013 and sales were up 4 per cent. Profit margins are nearing record levels, and companies in the consumer durable goods sector posted the strongest earnings. For 2015, US earnings growth is expected to slow to 5 per cent.

SEK INVESTORS BIG WINNERS FROM STRONG STOCK MARKET PERFORMANCE

REGION/COUNTRY (INDEX)	CURRENCY SEK	EUR	USD	NOK
Global (MSCI AC World NR)	40.3%	30.4%	7.9%	35.7%
US (S&P 500)	48.3%	38.3%	15.2%	42.5%
Europe (EuroStoxx 50)	23.2%	14.6%	5.3%	17.9%
Emerging markets (MSCI EM Index)	29.0%	19.6%	-1.8%	23.3%
Japan (Nikkei 225)	31.6%	22.2%	1.3%	25.4%
Sweden (OMXS 30)	26.0%	17.2%	-3.1%	20.9%

Source: Bloomberg

The performance figures in the table are for the period January 1, 2014 to February 23, 2015. There is a wide spread between the performances of the different exchanges. If we also take currency rate changes into consideration, Swedish investors have been the big winners. The benchmark global index generated more than 40 per cent in SEK, but only 8 per cent in USD. The US stock market measured in SEK tops the list, while Europe is at the bottom. European stock exchanges did worse than the broad S&P in the US last year, but have surged recently. The relatively weak figure for emerging market economies conceals very good returns in the Indian stock market, while Brazil has been a disappointment.

High valuations may pose a risk

Global corporate earnings overall are expected to grow more than 7 per cent this year and 12 per cent in 2016. Global equities are valued at a price/equity (P/E) ratio of 15 for this year and 13 for next year's earnings. This is on the high side from a historical perspective and may thus pose a risk and a limitation in terms of potentially higher share prices. US and Japanese companies are trading above their averages, whereas European listed companies look cheaper and are growing faster. Emerging market (EM) economies overall have a P/E ratio of 10 for 2016, which is attractive, but it should be kept in mind that EM growth has gradually slowed and is approaching the pace in the developed market (DM) sphere. In other words, we foresee increasingly synchronised growth rates around the world.

Large proportion of equities in our portfolios

We are cautiously optimistic about the potential for global stock markets in 2015 and still choose to hold a large proportion of equities in our portfolios. Forceful actions by the world's central banks, cheaper energy prices and large liquidity flows will provide support.

US macro statistics are showing strength. Some weakness is seen in the European Union and Asia. As a result, the US will continue to be the economic engine for moderate global growth. For a number of years, the US Federal Reserve (Fed) has skilfully navigated through difficult economic conditions and is now equally meticulous in preparing to raise its key interest rate in 2015 once the economy accelerates. A rate hike is already in the cards, but there is some doubt about when it will occur, which may create volatility. Lower oil prices combined with an improved labour market will gradually put more money in US consumers' pockets, and this will probably benefit companies that sell capital goods and consumer electronics, for instance.

Europe has potential

European purchasing managers are more optimistic. The European Central Bank and the central banks in non-euro zone countries are taking forceful action, including interest rate cuts and monetary stimulus measures to get the economic wheels spinning. The signals are still a bit mixed, but we foresee stabilisation and weaker currencies boosting exports. We prefer Europe to the US at present, since there is considerable potential for improvement. Growth is set to accelerate, with higher corporate earnings as a result. Furthermore, the US stock market has long outperformed the rest of the world, and valuations are starting to become stretched.

We see better potential generally in the DM than in the EM economies. Step by step, we have seen Chinese growth figures revised downward, admittedly at a controlled pace, but there is nonetheless some concern among investors about whether the country will succeed in its mission to achieve balanced economic growth going forward. Growth is likely to be around 7 per cent in 2015, with downside risks. The fact is that China has surpassed the US as the world's largest economy measured in purchasing power, and China's leaders are working methodically to exert global political influence in the long term. Nonetheless, the US will most likely continue to play the lead role in the global economy for quite a while.

REGION	WEIGHT*	REASONING
Globally	1 2 3 4 **5** 6 7	We have chosen to hold a large proportion of equities in our portfolios and prefer a broad global exposure. Forceful measures by the world's central banks, cheaper energy prices and large liquidity flows will provide support. Equities will be the main source of returns in today's ultra-low interest rate and bond yield environment. Globally synchronised growth will gradually have an impact on corporate earnings.
Europe	1 2 3 4 5 **6** 7	European purchasing managers are more optimistic, which bodes well for the region. The economy is bottoming out, and we see potential for upside surprises. Macro data are better, with stable trends, and fiscal policy is highly accommodative. We have overweighted Europe in our portfolios, since valuations and earnings growth look attractive. Companies are cost-effective and competitive, and benefit from weaker currencies.
US	1 2 3 4 **5** 6 7	The US is chugging along and leading the global economic recovery. Macro data are improving, and companies are in very good financial shape, with strong balance sheets and record margins. However, valuations are on the high side, which makes us a little more cautious. There is ever less potential for improvement, and the stock market has long outperformed the rest of the world.
Asia/EM	1 2 3 **4** 5 6 7	Faster global growth is beneficial to Asia and the EM economies. Low valuations are attractive, but earnings growth has gradually fallen and in many countries is approaching DM levels. Mixed macro statistics lead us to prefer the DM economies at present. In the EM sphere, we generally prefer Asia to Russia and Latin America.
Japan	1 2 3 **4** 5 6 7	Macro data are mixed and fiscal policy is supportive. A weaker Japanese yen has benefited exports. Valuations have come down to reasonable levels, but high earnings growth will slow this year. Stock market performance will depend on whether political stimulus measures can be implemented in their entirety or not. Source: SEB

** "Weight" shows how we currently view a region. Level 4 is a neutral stance. These weights are changed continuously based on our tactical market view and may thus diverge from our long-term strategic view of a region.*

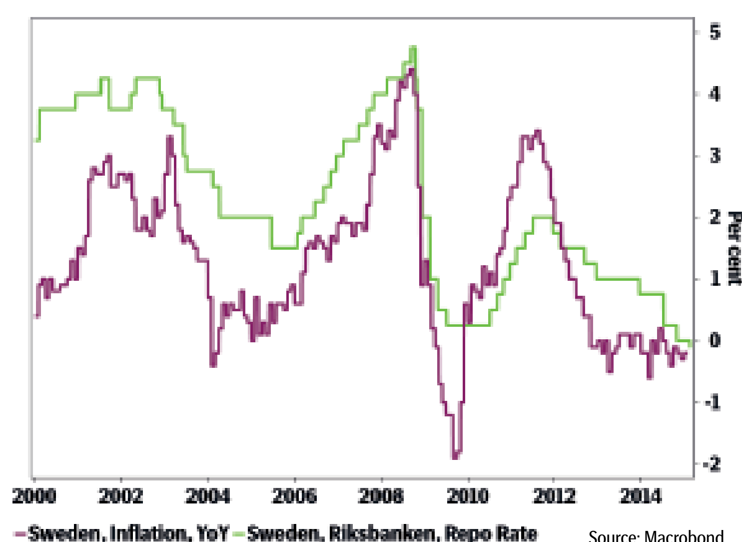
Monetary policy further into unknown territory

- **Central banks have cut key rates below zero and are expanding bond-buying**
  Negative interest rates have proliferated recently among central banks, as have negative yields in the government bond market, while the Bank of Japan and the European Central Bank are expanding their bond purchases. Yields may go even lower in the short term, but will then gradually climb in the US and Europe.

- **High yield corporate bonds still attractive to some extent...**
  The high yield (HY) corporate bond segment had a rough 2014, as yields on bonds issued by US energy companies surged with the collapse in oil prices. General financial and economic concerns also affected the HY market, but companies are still fundamentally in good financial health and the prospects of bankruptcies are not worrisome as long as the macro economy is growing and companies' interest expenses remain historically low.

- **... and EM debt will offer some potential later in the year**
  In the short term, expected returns on bonds issued in the emerging market (EM) sphere will be low. This applies mostly to bonds in oil-producing countries that also risk a decline in their currency, whereas countries that are net oil importers and have strong economic ties to the US are better positioned. Later in the year, investor interest in EM debt may increase somewhat as EM growth picks up, oil prices rise, uncertainty about the Federal Reserve's policy eases and EM currencies strengthen.

SWEDEN'S RIKSBANK DOING ALL IT CAN TO PUSH UP INFLATION



Source: Macrobond

There is a high correlation between inflation in Sweden (in the chart, measured as rolling 12-month changes in the consumer price index) and the Riksbank's benchmark repo rate. At the same time, inflation has rarely been close to the central bank's 2 per cent target. The trend since early in the new millennium has been below-target inflation. Despite repeated cuts in the repo rate, from 1 per cent in late 2013 to zero in October 2014, Swedish inflation has continued to fall. Lowering the repo rate to -0.10 per cent in mid-February should be seen in this context. Combined with other measures, this shows that the Riksbank is now doing everything it can to eventually reach its target.

In September 1992, Sweden's Riksbank hiked its key interest rate, called the marginal rate (predecessor of the repo rate), to an unbelievable 500 per cent. This was done to protect the Swedish krona's pegged rate to the European currency unit or ecu (predecessor of the euro), which was threatened by massive currency outflows from Sweden. As we know, this defence of the fixed exchange rate failed. At 2.28 p.m. on November 19, 1992, the krona was floated and immediately plunged in value.

In February 2015, the Riksbank lowered its repo rate to minus 0.10 per cent, actually a larger step into unknown interest rate territory than the key rate increase to 500 per cent in 1992. The Riksbank thus became one of the first central banks in the world to set its most important interest rate at below zero. This time the reason for the interest rate cut and other measures announced at the same time – the purchase of Swedish bonds, preparations to lend funds to small and medium-sized companies via banks, the introduction of a -0.20 per cent Riksbank deposit rate for banks and a downward revision of the central bank's interest rate forecast path – was to reverse falling inflation expectations in Sweden, in order to eventually achieve the 2 per cent inflation target.

The Swedish krona tumbled in response to the Riksbank's February 12 announcement. The decline was by all accounts welcomed, since a weaker krona raises Swedish import prices. This in turn may cause Swedish prices to rise, reigniting inflation (read more in the *Currencies* section).

Changes in key interest rates come under the category of conventional monetary policy, whereas central bank purchases (or sales) of financial assets – quantitative easing or QE – are called unconventional monetary policy.

In mid-February, the Riksbank thus took its first unconventional step when it announced SEK 10 billion worth of Swedish government bond purchases. Other more globally influential central banks have already travelled far down that path.

After historically large bond purchases that began shortly after the Lehman Brothers collapse on September 15, 2008, the US Federal Reserve (Fed) ended its bond buying programmes at the end of October last year. The Bank of England had done the same previously. In contrast, the Bank of Japan and the European Central Bank (ECB) will both be major bond purchasers for a long while going forward. In mid-January, the ECB launched its expanded programme to buy bonds and other fixed income securities, and the plan is to make monthly asset purchases totalling 60 billion euros from March 2015 to September 2016.

What is the outlook for interest rates?

So far this year, some 20 central banks around the world have launched new monetary easing measures, while a few – including Brazil's central bank – have tightened policy. By all accounts, this pattern will persist for the rest of 2015, even taking into consideration expectations that the Fed will start raising interest rates in September. In contrast, the Fed's unconventional path will be neutral this year; the central bank will not launch any net bond sales. Overall "global monetary policy" may thus remain highly stimulative in 2015 as well.

Central banks in many countries have more or less run out of ammunition for their interest rate weapons; key interest rates are close to or even below zero, which is why further stimulus measures will largely be carried out using unconventional tools – financial asset purchases. Does this mean that government bond yields will fall further, some even deeper into negative territory? That is unlikely, except in the really short term. If the ECB is successful in getting inflation expectations in the euro zone to start rising, then European government bond yields should gradually climb beginning in the spring and going forward. That would be a similar reaction to the one seen in the US when the Fed launched its third round of unconventional bond-buying (QE3).

Prospects of slightly better euro zone economic performance also suggest rising European bond yields. US bond yields will probably rise more as a result of the Fed's monetary policy approach, lower deflation risks than in Europe and a stronger US economic upturn.

Rising interest rates and bond yields will mean risks of falling prices for government bond investors. However, one reservation is that the ECB's government bond-buying, beginning in March and continuing, will clear the market of German bonds in particular, which in itself suggests that yields on these bonds will not rise.

ASSET TYPE	WEIGHT*	TACTICAL EXPECTED YEARLY RETURN		RISK	
		SEK	EUR	SEK	EUR
Cash	**1** 2 3 4 5 6 7	-0.2%	-0.2%	0.1%	0.2%
Government bonds	**1** 2 3 4 5 6 7	0%	-0.2%	4.0%	4.0%
Investment grade corporate bonds	1 **2** 3 4 5 6 7	0.5%	0.5%	2.5%	2.5%
High yield corporate bonds	1 2 3 **4** 5 6 7	4.0%	4.0%	4.0%	4.0%
Emerging market debt	1 2 3 **4** 5 6 7	6.0%	6.0%	9.5%	10.0%

Source: SEB

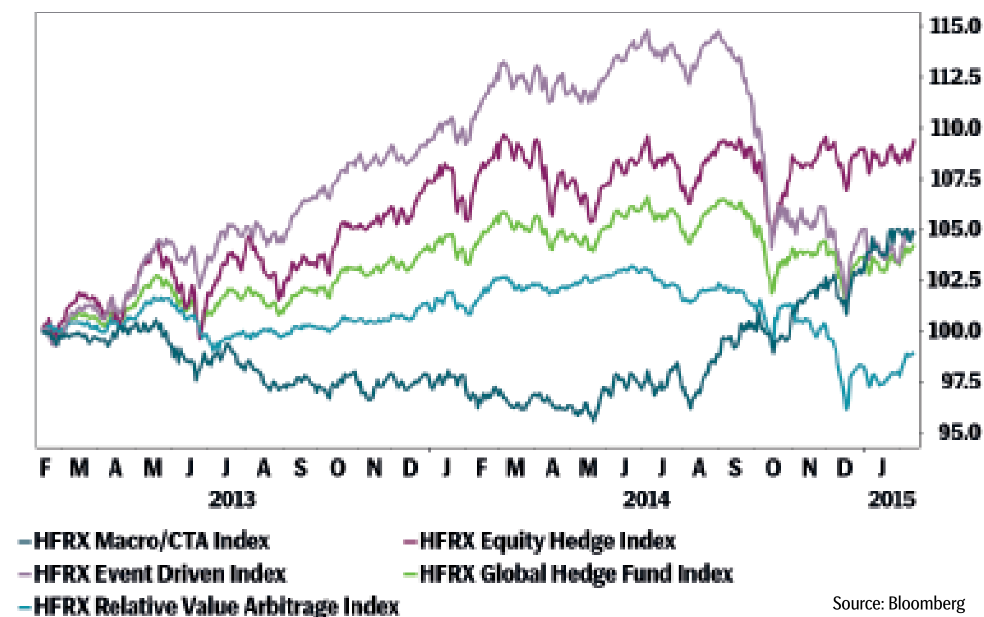
** "Weight" indicates how we currently view each asset type as part of a portfolio. Level 4 is a neutral stance. These weights change continuously depending on our tactical market outlook and may therefore differ from our long-term strategic outlook for the asset type.*

Fluctuating conditions for hedge funds in 2014 will probably persist in 2015

- **Widely varying return profiles for different strategies**
  During the first half of 2014, event-driven strategies were winners and trend-following strategies were losers. During the second half, the situation was the reverse.
- **The lack of other sources of return bodes well for the stock market and equity long/short strategies**
  The stock market is increasingly attractive in a stimulated global economy, and greater variation is expected in the performance of individual shares, which looks promising for equity long/short strategies.
- **Recovery potential for event-driven strategies after a weak end to 2014**
  Acquisition activity remains high, especially cross-border transactions between different regions. Strong balance sheets and higher demands for company efficiency improvements also bode well for event-driven strategies.

In the best of worlds, hedge funds deliver stable risk-adjusted return flows year after year. Their correlation with other asset classes is quite low. This helps reduce the risk in a portfolio that consists of equities and bonds as well as hedge funds, while at the same time increasing the expected risk-adjusted return. Today, however, the hedge fund world tends not to be quite so perfect and homogeneous. Different strategies have varying potentials and approaches; a market situation that may be highly favourable for one strategy may be the exact opposite for another. The performance of the different strategies in 2014 clearly shows how a change in market conditions can rather quickly change return potential in both a positive and negative direction. On the following page we attempt to describe the drivers that we see in each main strategy for the current year.

SELECTIVITY BETWEEN STRATEGIES IS IMPORTANT AS CONDITIONS SHIFT GREATLY



Source: Bloomberg

In past years, we saw abrupt shifts in the performance of trend-following and event-driven strategies in particular. This year began the same way that 2014 ended, and there is reason to believe that the rest of the year will see fluctuating conditions.

Equity long/short

Last year was difficult for equity long/short strategies in general and for European fund managers in particular. What is promising for such strategies in 2015 is that the stock market is increasingly attractive in a stimulated global economy and there is a lack of other sources of return. We also expect to see greater variation in the performance of individual shares. Since volatility has increased recently, fund managers who have an opportunity to change their net exposure relatively quickly are preferable.

Relative value

The central banks' extremely loose monetary policies have produced historically low interest rates and bond yields as well as narrow credit spreads, conditions that we believe will persist for the rest of the year. This will reduce the range of potential sources of return as well as liquidity in the underlying market. However, decreased co-variance between individual securities may create opportunities, and we prefer fund managers who work long/short rather than those with a long bias.

Event-driven

This type of strategies ran into trouble in 2014 because of a new US law that reduces opportunities for American companies to acquire European ones in order to achieve tax benefits. That led to a price decline for such investments, and event-driven strategies as a whole thus lost ground. Nonetheless, we see fundamental factors pointing to a recovery in 2015. Acquisition activity remains at a high level, with an especially large increase in cross-border transactions between different geographic areas. Strong balance sheets and higher demands for company efficiency improvements also bode well for event-driven strategies.

Macro/CTA

Clear communication from the world's central banks means more predictable macroeconomic trends, which makes life easier for macro strategy managers. Continued large differences in regional growth prospects will probably lead to lower correlations and create potential investment opportunities.

CTA trend-following strategies started off 2015 on the same strong note that they ended on last year. We believe there are lower correlations between different asset classes and clearly divergent price trends – factors that should continue to benefit these strategies. The strong start to the year may lead to short-term market corrections, but at the same time investor appetite has far from decreased.

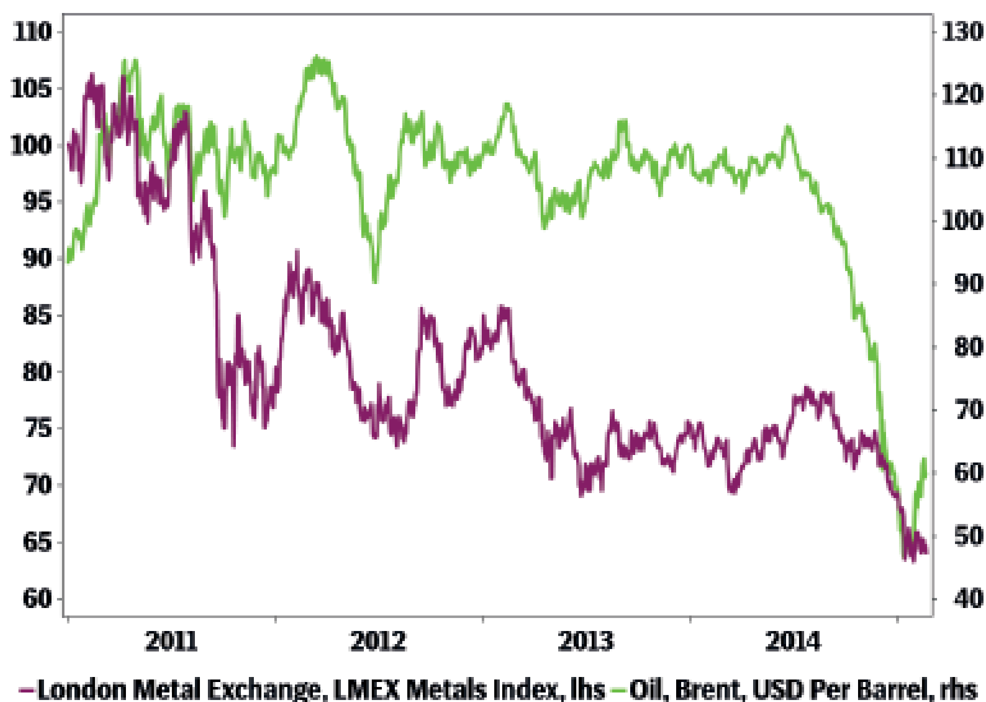
STRATEGY	INDEX	PERFORMANCE IN % (USD)				
		Jan 1-Feb 20, 2015	2014	2013	2012	2011
Global hedge	HFRX Global Hedge Fund	1.1	-0.4	6.7	3.5	-8.9
Equity hedge	HFRX Equity Hedge	0.9	1.5	11.1	4.8	-19.1
Relative value	HFRX Relative Value Arbitrage	1.1	-2.9	3.0	3.6	-4.0
Event-driven	HFRX Event Driven	0.7	-4.0	13.9	6.0	-4.9
Macro/CTA	HFRX Macro/CTA	1.9	5.5	-1.8	-1.0	-4.9

Source: SEB

Continued decline for oil, industrial metals

- **Downward revision in forecast for demand growth is a trigger**
  The International Energy Agency's downward revision in its demand forecast last summer was one of the factors sparking a decline in oil prices. The organisation's most recent demand forecast is an increase of 0.6 million barrels/day in 2015, compared to its forecast of 1.1 million barrels/day as recently as December 2014.
- **Our forecast is market balance this autumn**
  We expect a continued surplus in supply during the first half of 2015, but the global oil market will then become relatively balanced during the second half. We do not foresee any decision to cut production at the OPEC meeting in early June.
- **Conditions are in place for gradually rising metal prices**
  Because of continuously improving economic conditions, combined with expectations of increased metal demand in Europe, we are now forecasting rising industrial metal prices. However, developments in China's real estate and construction sectors are an uncertainty factor.

BIG PRICE DROPS FOR OIL AND INDUSTRIAL METALS, BUT DIFFERENT TIME SPANS



Source: Bloomberg/Macrobond

As the chart shows, oil prices have fallen by nearly half since mid-2014, a decline that has attracted a lot of attention. For industrial metals, the decline has been almost 40 per cent, but since this decline began four years ago, the market's reaction has been far less dramatic.

After continuing to fall sharply during the autumn, Brent crude – a benchmark North Sea oil – was trading at just over USD 70/barrel when we published the last issue of *Investment Outlook* (December 2, 2014). At the time, we forecast higher oil prices during 2015 but at the same time we noted the possibility that they would fall first. With the benefit of hindsight, we see that oil prices continued to plummet, with the benchmark falling below USD 50/barrel in mid-January. Since then, prices have been volatile; at this writing, oil is trading at just over USD 60/barrel.

One of the factors triggering the price decline last summer was the International Energy Agency (IEA)'s sharp downward revision in its demand growth forecast for both 2014 and 2015 (which it subsequently revised further downward). In its latest report, the IEA anticipates a demand increase of 0.6 million barrels/day for 2015, compared to the increase of 1.1 million barrels/day that it forecast as recently as December. In addition to global demand not rising in line with previous forecasts, there are three main factors behind the sustained fall in oil prices. First, the Organisation of the Petroleum Exporting Countries (OPEC) has not cut production to achieve market balance, as assumed in these forecasts; OPEC has instead increased production somewhat, leading to a sharp rise in oil stockpiles (US levels are at their highest in 30 years). Second, US shale oil production has been surprisingly resilient to lower oil prices. Finally, the sharp appreciation in the US dollar has led to a far smaller decline in oil prices denominated, for instance, in Swedish kronor.

We expect continued excess supply during the first half of 2015, but market balance should be reached during the autumn. Prices will probably be volatile, and we cannot rule out levels of around USD 40/barrel at times during the spring. Since the global oil market is expected to be relatively balanced during the second half, we do not anticipate any decision to reduce production at the OPEC meeting in early June.

We already see indications of slightly higher demand as a result of lower prices. US petrol prices have fallen by almost half since July 2014. Moreover, lower oil prices bolster the global economy. We also expect land-based US production to fall somewhat during the second half. We are already seeing a decline in the number of oil rigs in service.

Our current forecast is that oil will reach USD 70/barrel by year-end and will then remain around that level in 2016.

Metal prices have also dropped sharply

Oil prices have fallen by half in about six months, thus attracting considerable attention. However, the decline in metal prices has been under way for several years. From its peak in early 2011 to today, the benchmark London Metal Exchange (LME) Index has fallen almost 40 per cent, weighed down by weaker than expected economic conditions and in particular by uncertainty about Chinese growth.

A steadily improving economy, with extra stimulus from lower oil prices, and expectations of increased metal demand in Europe after the European Central Bank's package of quantitative easing (QE) measures has led us to now expect gradually rising industrial metal prices. Developments in China's real estate and construction sectors are an uncertainty factor, but there are positive indications in those sectors as well.

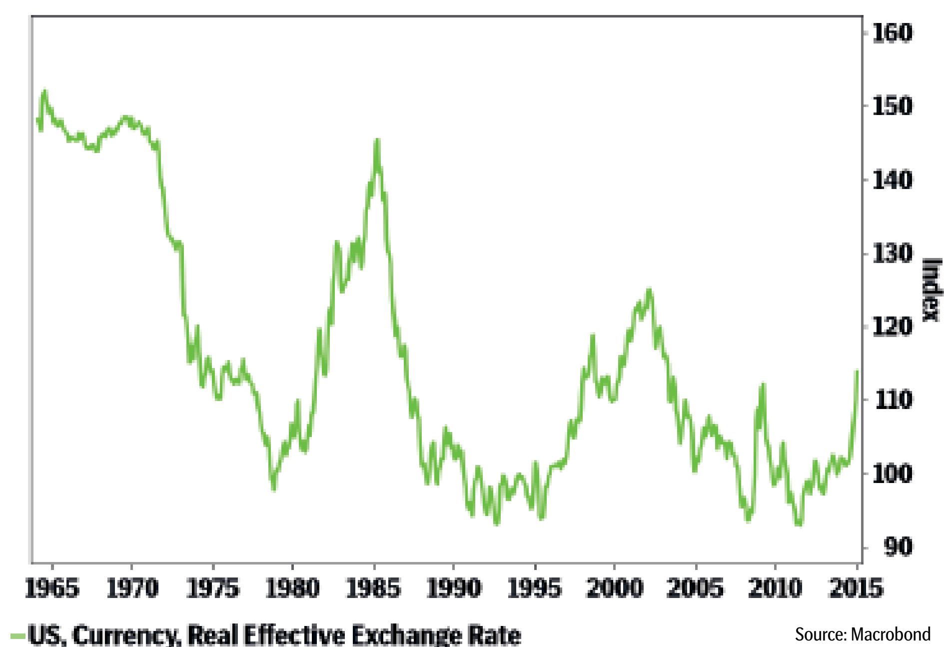
Central banks tempted by currency weapon

- **The US dollar is buoyed by a strong economy and by Federal Reserve policy**
  While the US economy continues its rapid growth and the Federal Reserve is expected to introduce interest rate hikes in the autumn, the economies of the euro zone and Japan are growing far more slowly. Both the European Central Bank and the Bank of Japan will continue to buy financial assets on a large scale, so the US dollar will strengthen against the euro and yen.

- **Sharp global currency movements are creating tensions in the foreign exchange system**
  The sizeable appreciation of the US dollar against the euro and Japanese yen has created great tensions in the global foreign exchange system, with consequences for monetary policy in countries such as Switzerland and Denmark, where the central banks lowered their deposit rates for banks to -0.75 per cent. Sweden's Riksbank cut its repo rate to below zero, causing the krona to plunge. This may help trigger higher prices and prevent continued deflation.

- **Widely divergent conditions for currencies in the EM sphere**
  Emerging market (EM) economies with currencies linked to the strengthening US dollar have been hit by competitiveness problems, which in some cases have been countered with monetary stimulus measures. Economies that are net oil exporters and do not get much of a boost from the strong US economy are in a far worse position than net oil importers with a large share of their exports going to the US.

SURGING DOLLAR – BUT STILL FAR FROM PREVIOUS PEAKS



Source: Macrobond

One focus of the foreign exchange market since last spring has been the US dollar's sharp appreciation against most other currencies (the chart shows the real effective exchange rate, which is the nominal USD trend versus a large basket of other currencies adjusted for the US price trend). The upturn this past quarter has created great tensions in the international foreign exchange system, but from a longer historical perspective, the dollar is not especially strong today.

The US economy will grow rapidly in 2015 and 2016, and the Federal Reserve (Fed) is expected to gradually tighten its monetary policy. Late last year, the Fed ended its bond-buying programme, and SEB predicts that this autumn the Fed will begin gradually hiking its key interest rate. Meanwhile the economies of the euro zone and Japan are growing far more slowly, and both the European Central Bank (ECB) and the Bank of Japan will keep their key interest rates at around zero during 2015-2016. The two central banks will also continue to purchase financial assets on a large scale.

USD, EUR and JPY

These divergent macroeconomic and monetary policy paths clearly point to the continued strengthening of the US dollar (USD) against both the euro (EUR) and Japanese yen (JPY). SEB predicts that by late 2016 the USD will have achieved parity (1:1) with the EUR and climbed to 140 against the JPY, compared to foreign exchange (FX) rates at this writing of USD 1.13 per euro and JPY 119 per dollar respectively.

Key factors in this forecast of sustained USD appreciation are the Fed's monetary policy actions and the oil price trend. If the Fed decides to delay its first rate hike because of surprisingly low inflation in the US – in the wake of falling oil prices and a stronger dollar, which would reduce US import prices – the USD would lose an important force driving this currency appreciation.

There is a strong historical connection between oil prices and the USD. Cheaper oil and a stronger USD go hand in hand, as do more expensive oil and a weaker USD. The strength of the USD this winter can thus be seen in light of the dramatic fall in oil prices.

In SEB's view, (Brent) oil will average USD 60/barrel this year and USD 70/barrel in 2016. These forecasts are consistent with continued USD appreciation against the EUR and JPY, due to differences in growth rates and monetary policy paths (see above). But should oil prices skyrocket, for instance to around USD 100/barrel, then it is unlikely that the USD would rise in value according to our forecast.

Both historically and in our forecast, large movements between global currencies like the USD, EUR and JPY create tensions in the international foreign exchange system, with resulting implications for monetary policy. Current examples illustrate this:

CHF och DKK

After quite unexpectedly abandoning the Swiss franc's cap against the EUR of around 1.20 in mid-January, the Swiss central bank lowered its deposit rate for banks to -0.75 per cent in an attempt to curb the strengthening of the CHF following removal of the cap. Shortly after, Denmark's central bank was also forced to cut its deposit rate to -0.75 per cent in stages. Its purpose was to counter the large capital flows into Denmark when speculation grew that the krone (DKK) would likewise no longer be pegged to the EUR and that the DKK in that case – like the CHF – would rise in value. In our view, the DKK's peg to the EUR will continue, although large sales of DKK and purchases of other currencies may continue for a while. Less than a month after the Swiss National Bank's dramatic announcement, Sweden's Riksbank shook the financial world by cutting its repo rate to -0.10 per cent. At the same time, an interest rate "corridor" was reintroduced for the Riksbank's fine-tuning operations, and the central bank's deposit rate for banks was set at -0.20 per cent.

SEK

The Swedish krona plunged after the Riksbank's interest rate announcement in mid-February, and while it never said so explicitly, the Riksbank was probably pleased with how the krona reacted. After all, a falling SEK exchange rate increases the prices of Sweden's imports. As a result, Swedish prices may rise, which may enable the Riksbank to achieve its 2 per cent inflation target later on.

These financial events in Switzerland, Denmark and Sweden highlight the close relation between monetary policy and events in the FX market, and illustrate how monetary policy is now used as a weapon to prevent currencies from strengthening (too much), or to make currencies fall in value.

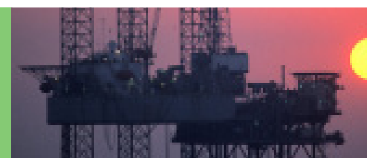
The background is that weak or weaker currencies protect a country's competitiveness and benefit growth, while making it easier to prevent deflation and instead make prices rise. But all countries' currencies cannot depreciate at the same time; some must also appreciate. So the concept of a currency war has taken on new relevance.

EM currencies

Growing FX tensions are also apparent in the emerging market (EM) sphere, tensions which in some cases may lead to monetary policy measures in response. Countries in Asia and Latin America whose currencies are linked to a strengthening USD are being hurt by competitiveness problems. Singapore's decision in early 2015 to slow the appreciation of its currency, the Singapore dollar (SGD), against the USD is one example.

Current account problems are alleviated if countries are net oil importers, which is true of Asia's EM countries. China's balance with the rest of the world clearly benefits from cheaper oil, but a likely simultaneous strengthening of the Chinese yuan (CNY) against the USD is expected to trigger additional monetary stimulus measures over the next few months by the People's Bank of China.

Many commodity-exporting countries in Latin America are in a worse position, especially Brazil, which has struggled with the combination of a stagnant economy, high inflation and a strengthening of the real (BRL) against the USD so far during 2015. Our forecast is that Brazil's key interest rate will be raised somewhat this spring – despite the stagnation – while the BRL will further strengthen somewhat. At least in the short term, the Brazilian economy will thus be subject to really strong headwinds.



Theme: Oil price decline both helps and hurts

Net oil exporters in the emerging market (EM) sphere are the biggest losers from the oil price decline, while net oil importers in the EM sphere are the biggest winners. There are also attractive stock markets in the winning countries.

Oil price trends are a key factor in what happens to the economy and in risk asset markets. Large price hikes in the early and late 1970s were followed by sharp downturns in the economy and in global stock exchanges. The same was true of the oil price hikes in 2007-2008. On the other hand, falling oil prices in conjunction with the peak of the financial crisis during the winter of 2008-2009 helped the global stock market and the economy to climb during the second half of 2009.

From 2011 to late spring 2014, oil prices were unusually stable, with Brent crude trading between USD 110 and 120 per barrel. Then came a dramatic decline, and by January 13, 2015, the benchmark had fallen to USD 46.50/barrel – a decline of almost 55 per cent from the second quarter of 2014. Since then, the price has rebounded to USD 60/barrel.

There are a number of reasons behind falling oil prices. The oil supply has increased – especially in the United States, Brazil and Canada – while the Organisation of the Petroleum Exporting Countries (OPEC), an oil cartel, has chosen not to cut production. Meanwhile, demand has fallen as a result of decelerating growth in the oil-thirsty emerging market (EM) sphere and generally more efficient oil use around the world. An estimated 70 per cent of the price drop is due to increased supply and 30 per cent is due to falling demand. Another factor is the strong historical connection between USD movements and oil price movements measured in USD/barrel, illustrated most recently by the price decline since early last summer and the simultaneous strengthening of the dollar.

The positive overall impact on global gross domestic product (GDP) of an oil price decline of around 50 per cent is estimated to be about 1.25 percentage points over the following two years. This effect is mostly a result of substantial financial resources being transferred from oil-producing to oil-consuming countries (about USD 1.9 billion is transferred given a 50 per cent price drop). Since the propensity to consume any additional income is higher in oil-consuming countries, this benefits global economic growth. It is also worth noting that the nearly 50 countries whose oil production revenues represent between 2 and 70 per cent of their GDP only account for about 25 per cent of total global GDP.

The main mechanisms causing economic growth to increase around the world when oil prices fall are higher household incomes after inflation and taxes (purchasing power) and lower input costs for companies. Lower inflation or a higher risk of deflation (a general fall in prices) may also lead to additional monetary stimulus measures, illustrated most recently by the European Central Bank's expanded bond-buying programme and the Riksbank's reduction in its repo rate to less than zero.

But the overall effect is now being eroded as households, companies and governments in oil-importing countries use some of their increased financial resources to reduce deficits,

OIL PRICES HAVE GREAT POWER OVER THE ECONOMY

Dramatic oil price fluctuations have a significant impact on global growth. Price increases in 2007 and the first half of 2008 helped deepen the subsequent economic downturn, while falling prices in late 2008 contributed to the economic recovery that began in the summer of 2009. Despite a price rebound in early 2015, oil is now almost 50 per cent cheaper than in late spring 2014, giving global growth a healthy push.

pay back loans and increase savings in response to the sizeable debt they took on during the financial crisis of 2008-2009. It should also be noted that, while oil prices have fallen about 50 per cent in USD, currencies such as the Japanese yen, euro and Swedish krona have significantly weakened against the dollar at the same time. This means that the oil price decline measured in these currencies has been less than 50 per cent. Falling oil prices also have a downside, for instance for the US energy sector. It has announced reductions in capital spending plans over the next year, which will affect US GDP growth. In light of this, it is reasonable to expect that an oil price decline in USD of about 50 per cent in net terms will accelerate global GDP growth by about 0.75 percentage points over the following two years.

In geographic terms, it seems that oil-exporting countries are losers when oil is cheaper, while oil-importing countries appear to be winners. But what do things look like behind the aggregate figures – who are the biggest winners and who are the biggest losers?

Step one in the analysis is to divide the world into four groups: 1) net oil importers in the emerging market (EM) economies, 2) net oil importers in the developed market (DM) economies, 3) net oil exporters in the DM economies and 4) net oil exporters in the EM economies.

Group 1 – benefits most from falling oil prices, since oil consumption as a percentage of GDP is high. Three fundamental variables that enable economies to improve as a result of cheaper oil are higher growth, lower inflation and better current account balances.

Group 2 – benefits when households gain more purchasing power and companies have lower input costs. As a result, growth is higher and inflation is lower, while there is little effect on current account balances (oil as a share of total imports is rather small).

Group 3 – the end result is a slightly positive economic effect, since net oil exports constitute a small share of GDP. The negative effect of lower oil production on total economic output and income is relatively small. Meanwhile, cheaper oil promotes economic growth in general via increased purchasing power and lower costs for companies. In this group, growth is somewhat higher and inflation is lower, but current account balances deteriorate.

Group 4 – the big loser. Here, both net oil exports and total oil production earnings represent significant percentages of GDP. Growth is lower and GDP falls, inflation is lower, and current account balances deteriorate significantly.

Group 1 includes China, India, Indonesia, South Korea, Singapore, Taiwan and Turkey. In group 2 we find Germany, France, Italy, the Netherlands, Spain, Sweden, Switzerland, the US and Japan. Group 3 includes Canada, Norway and the United Kingdom. Group 4 includes countries such as Kuwait, Saudi Arabia, the United Arab Emirates, Angola, Nigeria, Russia and Venezuela.

EM oil exporters

For many oil exporters in the EM sphere, oil earnings account for a significant share of GDP. In the Middle Eastern countries that share is between 25 and 55 per cent, in Angola 45 per cent, in Nigeria 15 per cent, in Venezuela 25 per cent and in Russia about 15 per cent. Falling oil prices therefore hit the economies and public finances of these countries hard.
At the same time, the financial resilience to withstand such shocks varies significantly among countries. The Middle Eastern countries show sizeable public budget surpluses and small government deficits. These financial ratios are fairly strong in Russia and relatively good in Angola and Nigeria (although government finances in Nigeria risk rapid deterioration if oil prices fall further), whereas the situation is far worse in Venezuela. If Venezuela were forced to default on its loans, which should by no means be ruled out, this would also have a noticeable effect on other countries since Venezuela has significant foreign debt.

DM oil exporters

Among oil exporters in the DM sphere, oil earnings are far less important than among those in the EM sphere. In Norway, the figure is about 10 per cent of GDP, in Canada about 3 per cent, and in the UK only 1 per cent. Greater dependence on oil earnings in the Norwegian economy, however, is offset by the sovereign wealth fund as well as sizeable national budget and current account surpluses. Still, in terms of the growth effects of falling oil prices, Norway is probably a loser, while the UK economy gets a push from cheaper oil (British oilfields in the North Sea have also quickly declined in importance when it comes to oil-related capital spending).

DM oil importers

DM economies that are net oil importers clearly benefit in terms of growth when oil is cheaper, but to varying degrees. The greatest positive effect is in countries where household oil consumption constitutes a high share of expenditures, energy taxes are low – which means that much of the oil price decline shows up in people's pockets, and saving is low (a large share of additional purchasing power is consumed).

The US best satisfies the three conditions for the greatest positive effect from falling oil prices. Compared to Europe,

VARYING DEBT LEVELS AMONG MAJOR OIL EXPORTERS

COUNTRY	DEBT, % OF GDP
Kuwait	5.9
Saudi Arabia	2.6
United Arab Emirates	11.4
Angola	38.4
Nigeria	10.4
Russia	15.7
Venezuela	46.2

Source: IMF

Oil exporters in the Middle East have good financial resilience when oil prices fall, given their small public debt. The situation is also good in Nigeria and Russia, whereas Venezuela is in a far worse position. Venezuela also has the largest foreign debt of these countries.

the US is characterised by higher per capita oil consumption (over 20 barrels a year, compared to 10 in Europe), significantly lower energy taxes and a higher propensity to consume. But because US oil production has taken on far greater importance in the economy thanks to the rapid growth of shale oil extraction, the positive net effect on US economic growth from falling prices is now substantially less than it is in Europe. The euro zone and Sweden get roughly the same boost, while Switzerland gets less of a helping hand from oil. For Japan, the positive bump in growth is on a par with that of the euro zone.

In general macroeconomic terms, as reflected in our macro model, Sweden, Switzerland and Germany rank high in this group of countries, while Spain, the Netherlands and the US are in the middle and Italy, France and Japan end up much further down.

EM oil importers

Over to oil importers in the EM economies, where growth benefits the most from falling oil prices. The largest net oil importers as a percentage of GDP (the biggest direct winners) are Singapore and Taiwan, followed by South Korea, India, Turkey, China and Indonesia. Oil consumption as a share of GDP is also highest in Singapore, followed by China, South Korea, Indonesia, Taiwan, India and Turkey. The household savings ratio is low in Indonesia and high in China, India and Taiwan. Information is not available for the savings ratio in Singapore and Turkey.

Other pieces of the puzzle in this analysis are provided by our macro model, where Singapore, South Korea, Taiwan and China top the list, while India, Turkey and Indonesia rank much further down.

What happens to the key interest rates and currencies in these countries is also important, both from a macroeconomic perspective and for investors who have other currencies as their base currency, such as the US dollar (USD), euro (EUR) or Swedish krona (SEK).

SEB predicts that China and India will lower their key interest rates for the rest of 2015, the Indonesian key rate will remain unchanged and the key rates in South Korea, Taiwan and Turkey will be raised. There is no key interest rate in Singapore; instead, monetary policy is centred on managing the exchange rate of the Singapore dollar (SGD) against a currency basket.

As for currencies, SEB's forecast is that towards the end of 2015 the following currencies will strengthen against the USD: the Indonesian rupiah (IDR), Singapore dollar (SGD), South Korean won (KRW), Chinese yuan (CNY), Indian rupee (INR) and Taiwanese dollar (TWD). However, the Turkish lira (TRY) is expected to fall somewhat. Since the USD is meanwhile expected to appreciate against both the EUR and SEK during the rest of 2015, EUR-based investors holding SGD, for instance, can count on a foreign exchange gain of almost 15 per cent.

Attractive stock markets in a number of countries

Many of the countries that are macroeconomic winners have a large export sector, and exporters are so well represented in the stock market in a number of these countries that other factors will probably be more important for earnings growth than what is happening in the domestic economy. In particular, the stock exchanges in South Korea and Taiwan but also in Sweden and Germany have a large element of multinationals and export companies. At the same time, companies with global operations in cyclical consumer goods such as automobiles and electronics dominate the stock markets of South Korea, Taiwan and Germany.

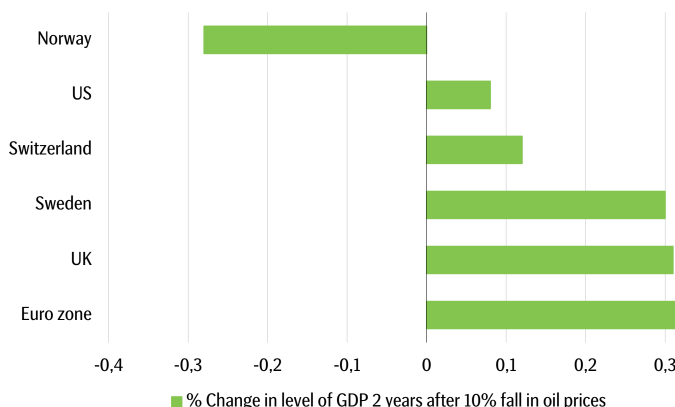
Since the above macro analysis assumes that lower oil prices will stimulate global growth, especially by increasing household purchasing power, we still think there is reason to believe that companies on these stock exchanges are relatively well-positioned to take advantage of cheaper oil.

Of course, there are also obvious losers on these stock exchanges when oil prices fall. For instance, energy is the second largest sector in the Hang Seng China Enterprise Index of Chinese H shares (shares incorporated in mainland China), with a weight of about 16 per cent. Similarly, Singapore and South Korea have world-leading shipyards with a focus on the offshore industry in their indices of large cap companies. Nonetheless, the winners outweigh the losers.

Relatively attractive valuations

Our model, which ranks 35 international stock exchanges based on valuations, earnings growth and earnings revisions, shows some countries that are relative winners in our macroeconomic analysis and that also have attractive valuations.

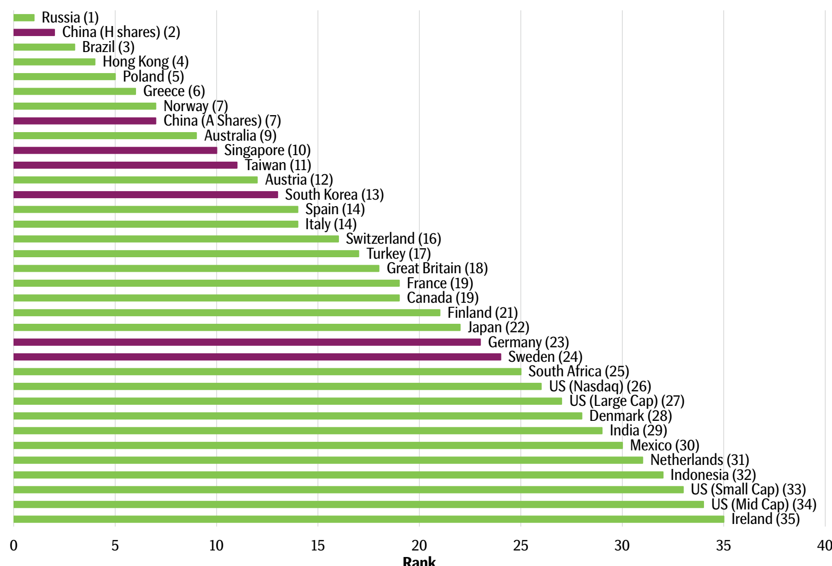
Chinese shares, especially so-called H shares listed in Hong Kong and readily available to foreign investors, are still among the cheapest in the world. Only the Moscow stock exchange



EUROPE BENEFITS MORE THAN THE US WHEN OIL IS CHEAPER

The positive effect on GDP of a 10 per cent fall in oil prices is far greater over the following two years in the euro zone, the UK and Sweden than in the US. Norway, a large oil exporter, will instead be hurt in GDP terms when oil prices fall.

INTERNATIONAL STOCK MARKETS, RANKED BY VALUATIONS



Source: SEB/Bloomberg

The chart shows stock markets ranked by their valuations, based on a combination of P/E ratio (consensus for 2014) relative to the market's historical (8-year) average, book value of equity compared to the historical average and current dividend yield (absolute level). A number of markets that should be able to benefit from cheaper oil and the general macroeconomic climate also have relatively attractive valuations.

is cheaper in a weighing together of P/E ratios and book values of equity, compared to the market's historical average and dividend yields in absolute figures.

Chinese A shares (listed in Shanghai and Shenzhen and available to foreign investors only to a limited extent) and shares in Singapore and Taiwan also have relatively low valuations and rank 7th, 10th and 11th respectively among the 35 markets.

Nonetheless, only in China (A shares) and South Korea do we see signs of the favourable macroeconomic conditions expected for earnings growth and/or in the latest revised forecasts. An improved macroeconomic environment should, after all, be reflected in improved earnings growth (at least for the domestically oriented companies in each market) and upward-revised forecasts.

Markets that benefit

Naturally, there are a number of other factors that will affect the earnings performance of listed companies in these markets, aside from the domestic macroeconomic environment and oil prices. The stock market is complex in each country. We nevertheless believe that at the margin, all of these markets should have more favourable conditions in relative terms as a result of cheaper energy and monetary or fiscal policy stimulus measures. Valuations for all of them are also at an acceptable or seemingly attractive level.

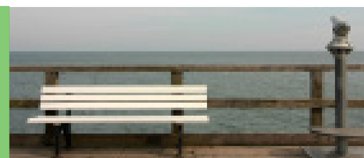
Even after their recent gains, equities have good potential to further increase in value due to a lack of return-generating alternatives and due to aggressive monetary policy by central banks around the world. All else being equal, the stock markets in Sweden, Germany, China, Taiwan, Singapore and South Korea should benefit from stimulus measures by both central banks and political leaders as well as cheaper oil, even somewhat more than the rest of the global stock market.

IMPORTANT FINANCIAL RATIOS FOR EQUITIES IN COUNTRIES WITH A GOOD MACRO POSITION

STOCK MARKET (INDEX)	P/E RATIO	P/E PREMIUM/ DISCOUNT AGAINST 8-YEAR AVERAGE	PBV PREMIUM/ DISCOUNT AGAINST 8-YEAR AVERAGE	DIVIDEND YIELD	EARNINGS GROWTH, 2014	EARNINGS GROWTH, 2015
China A (CSI 300)	12.8	-46%	-40%	2.1%	21%	15%
China H (Hang Seng China Enterprise)	8.2	-47%	-51%	3.8%	3%	11%
Taiwan (MSCI Taiwan)	13.0	-12%	11%	3.4%	15%	6%
South Korea (KOSPI 200)	10.2	-9%	-22%	1.6%	37%	8%
Singapore (Straits Times)	14.0	14%	-5%	3.3%	0%	10%
Germany (DAX)	14.1	19%	16%	2.9%	32%	10%
Sweden (OMXS 30)	16.6	41%	20%	3.8%	6%	8%

Source: Bloomberg

The above financial ratios are based on consensus data. The difference between Chinese H and A shares is due to the composition of the indices. In most cases, H shares in the same company are currently valued at a discount against their A share counterparts. A shares are represented by the CSI 300 Index of the 300 most liquid shares traded in Shanghai and Shenzhen. H shares are represented by the Hang Seng China Enterprise Index, consisting of the 40 largest Chinese shares on the Hong Kong exchange.



Markets in unknown bond yield territory

What everyone previously thought was impossible proved possible. Today many government bond yields, mainly in Europe, are negative. The reasons are many, but the actions of central banks have played a key role. According to our forecast, gradually rising government bond yields are imminent, but one complication will be the European Central Bank's impending appetite for German government bonds in particular.

In previous issues of *Investment Outlook*, we have mentioned and analysed the fact that the government bond market – illustrated by that of the United States – has shown regular 30-year cycles for more than a century. After the Second World War, government bond yields first trended upward until the early 1980s and then gradually declined – a movement that is perhaps not yet really over. What distinguishes the current phase of the downward trend from earlier counterparts is that yields on many government bonds, mainly in Europe, have now become negative, which has undoubtedly stretched the limits of forecasters' imagination.

What, then, explains why government (and a few corporate) bond yields have ended up in unexplored – and thus unknown – yield territory?

Three factors that have been regarded as crucial are: 1) expectations about where short-term interest rates and central bank key interest rates are headed, 2) inflation/deflation expectations in the bond market and 3) the "term premium".

The third factor reflects the compensation that bond investors want for holding a bond during a long or short period, with the rule of thumb being that the term premium on a ten-year bond is higher than the premium on a five-year one. This, in turn, has helped ensure that the "yield curve" – a chart showing yields on fixed income securities with different maturities – usually shows a positive slope.

The first two factors are, in a sense, two sides of the same coin. If bond market players have reason to believe that inflation will fall (disinflation, a declining rate of price increases) or even that prices will move from rising to falling (deflation), more and more bond market players will probably expect that in response to this, the central bank will lower its key interest rate. If it does, interest rates on short-term and money market securities usually fall.

Because of expectations of lower inflation or a shift to deflation, investors who buy bonds can lower their nominal interest rate demands. As a result, bond yields fall. If short-term interest rates fall at the same time, it also becomes cheaper to borrow in the money market in order to invest in the bond market, and heavier demand for bonds will cause their prices to rise and bond yields to fall.

HISTORIC FIRST: GOVERNMENT BOND YIELDS IN NEGATIVE TERRITORY

Source: Macrobond

Due to a combination of unprecedented monetary policy stimulus, an unusually slow economic upturn, growing deflation risks and demand for "safe" government bonds, many such bonds in Europe now carry negative yields. Other reasons behind the sharp decline in Swiss and Danish government bond yields are these countries' recent interest rate cuts (on their central bank deposit rates) for currency policy reasons. Switzerland took this step in order to limit the appreciation of the franc after abandoning its peg to the euro, and Denmark acted in order to maintain its euro peg.

From conventional to unconventional policy

Since the financial and economic crisis of 2008-2009, central banks have begun using a new policy tool on a large scale. Their traditional tool is making changes in key interest rates, which is called conventional monetary policy. Their new tool is the purchase (or sale) of financial assets, which is called unconventional monetary policy. This can be regarded as an additional, fourth factor affecting the path of bond yields.

While key interest rate cuts have a direct depressing effect on money market and bank account interest rates, central bank bond purchases have the direct power to push down bond market yields (but lower key interest rates may also have this effect). Of course increased demand for a product – in this case bonds – usually boosts its price. This is the same as saying that bond yields will fall. In other words, central banks have now activated tools that affect the entire yield curve.

For example, if the key interest rate is close to zero and the central bank implements or announces large government bond purchases, the yield curve for government securities may assume a negative slope and most of the curve may end up in negative yield territory. This is a phenomenon that is not described and analysed in today's university textbooks but that is now visible in various European national government bond markets.

Leading central banks – the US Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of England (BoE) – lowered their key interest rates sharply during the financial crisis 6-7 years ago. The Bank of Japan's key rate was already low before the financial crisis broke out, so its cuts were far more modest. Only the ECB has continued to slash its key rate further in recent years. Today, these "heavyweight" key interest rates range from 0.05 per cent (ECB) to 0.50 per cent (BoE), in other words close to zero. The only central bank that has pushed its key interest rate below zero is Sweden's Riksbank, which cut the repo rate to -0.10 per cent in mid-February.

As for unconventional monetary policy, also called quantitative easing (QE), the Fed was the first central bank to try it. The bank launched QE1 in the autumn of 2008, shortly after the collapse of Lehman Brothers in September that year. It followed up with QE2 and QE3. Its last bond purchasing programme concluded at the end of October 2014. QE1-QE3 added a full USD 3.7 trillion to the Fed's balance sheet. In the spring of 2009, the BoE initiated its own QE programme. When the programme ended in December 2012, the bank's balance sheet had swelled by GBP 375 billion.

Both the ECB and the BoJ, however, are continuing their financial asset purchases. In mid-January the ECB launched an expanded programme to buy EUR 60 billion worth of bonds and other fixed income securities per month. According to plans, the programme will run from March 2015 to September 2016. Of this monthly amount, government bonds will total around 40 billion. The remainder will consist of bonds issued by European institutions, covered mortgage bonds and asset-backed securities (ABSs).

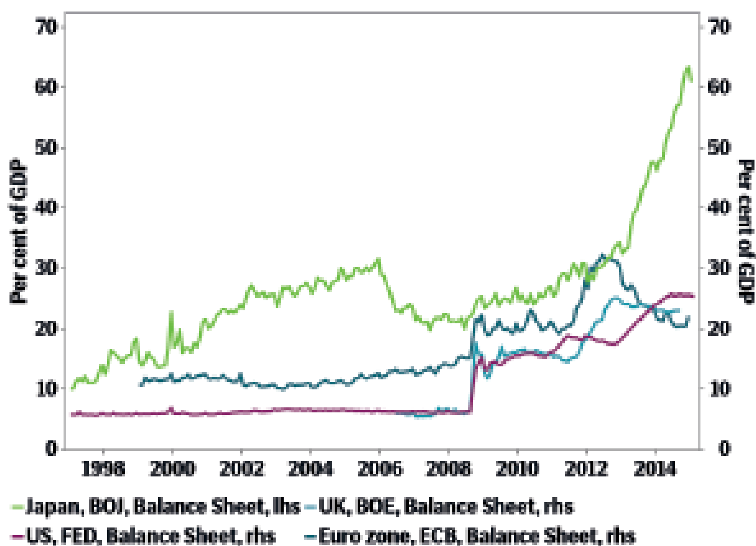
In October 2014, the BoJ increased its asset purchases to a pace of JPY 80 trillion per year. Compared to the ECB, the BoJ employs a broader spectrum of purchases, also including corporate bonds, real estate funds and equities. A recent newcomer to unconventional monetary policy is the Riksbank, which announced in mid-February when it cut the repo rate that it would purchase SEK 10 billion worth of Swedish government bonds.

Zero per cent bond yields – why?

What, then, has caused government bond yields to drop dramatically in recent years, nowadays in many cases to below zero?

By all indications, the central banks' aggressive interest rate cuts and massive bond purchases are the main reason. At the same time, there are several reasons behind the actions of the central banks.

UNCONVENTIONAL MONETARY POLICY, NOW WITH A MORE CONVENTIONAL TOUCH



Source: SEB/Macrobond

The Bank of Japan (BoJ) escalated its financial asset purchases early in the new millennium, while the Federal Reserve (Fed), Bank of England (BoE) and European Central Bank (ECB) followed suit when the financial crisis spiralled out of control in the autumn of 2008. This policy has contributed to the dramatic downturn in government bond yields. Today these central banks are pursuing different paths. The Fed and BoE have ended net bond purchases, while the BoJ and ECB continue this stimulus policy.

Helping sustain the economy

When the financial and economic crisis erupted in earnest during the fall of 2008, with the Lehman Brothers collapse as the trigger, there was every reason for central banks to take steps to safeguard the financial system, try to alleviate the economic downturn and then take steps to revive economic growth.

The economic recovery that began in the summer of 2009 – and which is still under way – has turned out to be strikingly slow and characterised by plenty of spare production capacity. As a result, cost and price pressures have remained low. There has thus been no reason for central banks to tighten monetary policy in order to combat unwanted high inflation. Meanwhile, the financial system has remained fragile since the crisis, so further bond purchases have been justified.

In recent years, Europe has suffered a series of sovereign debt crises, with Greece in the leading role (a role it continues to play), and with the other GIIPS countries (Italy, Ireland, Portugal and Spain) in prominent supporting roles. These crises – in spring 2010, summer 2011 and spring 2012 – helped weaken the European economy, reducing price pressures further.

This has prompted the ECB to launch several financial assistance programmes and has also helped boost demand for "safe" government bonds in Europe, mainly German bonds. When these crises reinforced the disinflation trend in the euro zone, there were increasing concerns that prices would even start falling in the currency union. In other words, the spectre of deflation was peeking out of its closet.

Inflation expectations

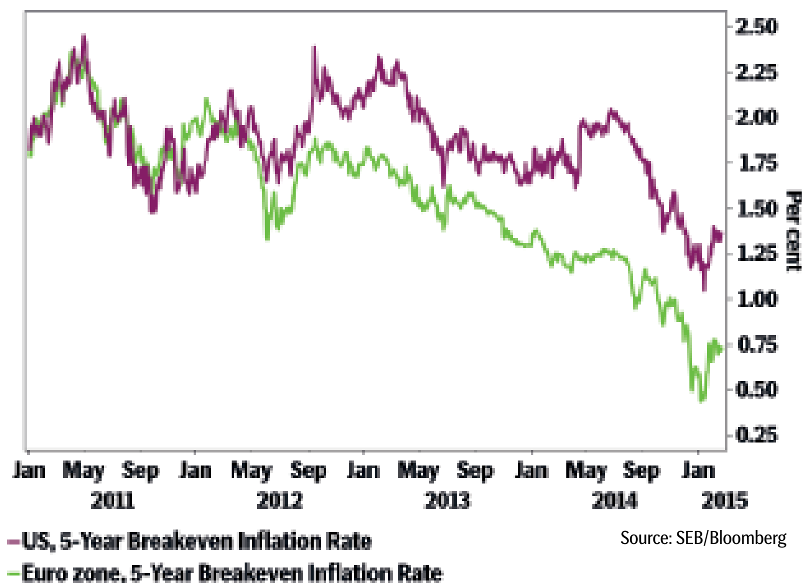
The next force that has pushed government bond yields sharply downward has been the fall in oil prices that began late last spring. Due to cheaper oil, both the US and the euro zone will report falling consumer prices this year, and the overall developed market (DM) sphere is likely to see stable prices during 2015. Analysts did not foresee this price situation a year ago, and the oil price decline is thus a factor that has justified even lower bond yields.

Many European government bonds today carry negative yields. This means that buyers of these fixed income securities are guaranteed a loss in nominal terms if they hold them to maturity. The fact that investors are still interested in buying them indicates that what was once normal no longer is.

One reason why investors may buy negative-yield bonds, despite these conditions, is perhaps that they expect bond yields to fall further and plans to sell the bonds with a capital gain before maturity. Or perhaps buyers expect a long period of deflation, which means that there may still be a positive return in real terms (if deflation exceeds the nominal loss).

Another reason may be exchange rate optimism. In other words, buyers believe that the currency in which they pay for their investments will fall in value against the currency in which the bonds are denominated. Investors thus expect their foreign exchange gains to be larger than any price decline on the bonds. Finally, there are investors such as pension funds that are forced to have government bonds in their portfolios due to various

AFTER A STEEP DECLINE, INFLATION EXPECTATIONS HAVE REBOUNDED IN BOND MARKETS



Source: SEB/Bloomberg

One of the factors that determine what path government bond yields take is inflation expectations. In both the US and the euro zone, these expectations fell steeply during the second half of 2014 (concurrently with the oil price decline), but this year they have rebounded, though to low levels. Assuming higher world economic growth, a stabilisation of oil prices at somewhat higher levels than today and a successful European Central Bank bond purchasing programme, inflation expectations should continue to rise – pulling government bond yields up with them.

regulations. The latter group includes the biggest losers from negative government bond yields.

Expectations for 2015

What, then, is the outlook for government bonds yields during the remainder of 2015? The four factors that determine the path of bond yields, as discussed above, will help us to answer this question.

Expectations about what will happen to the key interest rates of leading central banks (factor 1) are pointing in different directions. While “no one” expects the ECB and the BoJ to raise their key rates for a long time, there is a widespread belief that first the Fed and then the BoE will start their rate hiking cycles within the next year.

As for inflation expectations in the bond market (factor 2), after a marked decline since summer 2014, these expectations initially stabilised in 2015 and then climbed somewhat, both in the US and Europe. What happens during the rest of the year will depend largely on the extent to which the ECB manages to push inflation expectations higher with the help of its “60 billion programme”. If this effort succeeds, which is our main scenario, we should soon see gradually rising European sovereign bond yields as investors demand compensation for higher expected inflation.

An upward movement in bond yields on both sides of the Atlantic may also be fuelled by slightly better economic growth in the euro zone, strong US economic performance and the Fed's upcoming interest rate hikes, a stabilisation of oil prices at somewhat higher levels than today, and the fact that last autumn and early in 2015, bond investors apparently ignored the positive effects of lower oil prices on global economic growth.

A probable increase in the term premium (factor 3) also suggests higher government bond yields. This premium has reached historic lows in the US and especially in Europe. Current levels seem on the low side, given uncertainty about possible growth and price outcomes (economic forecasts may prove wrong), the future of the euro project, the consequences when central banks start to reverse their unconventional policies and geopolitical situations.

One challenge to our scenario would be if cheaper energy leads to surprisingly large price declines for other goods and services – with underlying inflation also turning into deflation in various countries. Another challenge would be if the ECB’s bond purchases (factor 4) lead to persistently low, perhaps even slightly lower, European government bond yields.

Of the ECB’s purchases totalling EUR 60 billion per month starting this March, some EUR 40 billion will consist of government bonds. These purchases will be allocated among countries according to the relative GDP of euro zone members. Meanwhile, the government’s borrowing requirement is particularly low in Germany, so ECB purchases of German government bonds – about EUR 120 billion over the next 12 months – will be significantly larger than the new issues of such bonds, which will total only a few billion euros.

The ECB's purchases during the period will also be equivalent to a significant proportion of gross German government bond issuance: a full 75 per cent. The EU will buy 55 per cent of government bonds issued in the entire euro zone until February 2016, a larger proportion of total bond issues than in earlier Fed, BoE and BoJ bond purchase programmes.

In other words, the ECB's actions may lead to a shortage of German government bonds in particular. Such a shortage may lead to rising prices. In the case of bonds, when the price goes up the yield goes down...