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Investment Strategy

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The world economic outlook has brightened. Many problems admittedly remain to be solved, but growth has broadened into many more countries and sectors. The investment environment continues to improve, and 2011 may be another good investment year.

The world is gaining economic strength. More and more regions are moving towards a cyclical upturn, and the growth situation is improving globally. Central banks in major industrialised countries are continuing to pursue accommodative monetary policies, and there are clear efforts to nurture growth around the world. This will be needed in order to overcome problematic government finances, especially in a still wounded Europe, but also in the United States.

There are many indications that the risks related to sovereign debt financing will remain over the next few years. There is a need to keep growth going and to generate higher employment, which in turn will lead to better tax revenues that can ease the problems. But in the meantime, sovereign debt will grow.

Another potential source of concern is the danger of inflation. In those emerging market countries that are furthest ahead in the economic cycle, inflation tendencies have led to tightening measures. Yet core inflation in China is still only 2 per cent, and in large portions of the industrialised world it is even lower. Inflation is thus probably still a limited risk – especially in the OECD countries.

One could argue that there will be a long, stable economic upturn this time around. Such an upturn is needed, since many sectors in the world economy are still underinvested. In addition, employment remains low in the industrialised countries, households in many places have been thrifty, and the growth in money supply is slow. The latter demonstrates that bank lending is not yet under way on a large scale. In capital markets, willingness to take risks is also still restrained.

The economy is an organic force. The desire to create new things and to make life better for oneself and those who are near and dear is a fundamental driving force, and the world’s policy makers will continue taking steps to help sustain it. Fundamentally, this will provide a good climate for investments. There are risks, as always, but the desire to generate growth is substantial.

Capital markets have provided good returns in the past year, and there are many indications that 2011 will be another good year. We will experience various reversals. Today there is perhaps a little too much agreement that the picture is bright. This has driven up stock markets. In itself, this may be one reason for some short-term caution. But aside from brief disruptions, there are many signs that 2011 will also be driven by greater demand from investments and growth. More and more regions are demanding resources, which may push up prices somewhat and contribute to sales profits and growth.

In bond markets, much is happening in the wake of the new Basel III rules. European banks are issuing new financial instruments to strengthen their capital bases, and this is probably a pattern we will see during the year. For us as investors, this creates attractive new potential returns. We can even foresee a renaissance for the old convertible bonds.

As the economic cycle moves forward, the climate for alternative investments will improve. For private equity companies, this is precisely the phase when the best funds are built up. Credit remains something of a tight sector, at the same time as companies are not overvalued and serious market players have little competition. Overall, this is a good situation. In a few years the last phase of the cyclical upturn will occur. By then, more and more investors will be searching for private equity transactions, which will then tend to be less and less profitable. It is better to carry out such transactions now, when companies have not yet had time to become expensive.

HANS PETERSON
CIO Private Banking
and Global Head of Investment Strategy
**Summary**

**Expected. 1-2 years (annual averages)**

<table>
<thead>
<tr>
<th></th>
<th>Return</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equities</strong></td>
<td>10%</td>
<td>16%</td>
</tr>
<tr>
<td><strong>Fixed income</strong></td>
<td>5%*</td>
<td>6%</td>
</tr>
<tr>
<td><strong>Hedge funds</strong></td>
<td>7.5%</td>
<td>6%</td>
</tr>
<tr>
<td><strong>Real estate</strong></td>
<td>4.5%</td>
<td>3%</td>
</tr>
<tr>
<td><strong>Private equity</strong></td>
<td>15%</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Commodities</strong></td>
<td>9%</td>
<td>18%</td>
</tr>
<tr>
<td><strong>Currencies</strong></td>
<td>3%</td>
<td>3%</td>
</tr>
</tbody>
</table>

**Reasoning**

**Equities**

**POSITIVE.** The economic picture will continue to strengthen. Both strategically and tactically, the outlook is positive even though caution will prevail in the short term. The US and Europe are the regions with the largest potential for growth surprises.

**Fixed income**

*Expected risk and return on corporate bonds that are weighted about 1/3 Investment Grade and 2/3 High Yield.*

**Hedge funds**

**POSITIVE.** The improved market situation is an argument for hedge funds. Their diversification characteristics have weakened but should be able to resume as the market normalises.

**Real estate**

**POSITIVE.** More stable growth and a more stable economic environment, as well as continued discounts of around 25-30 per cent to net asset values, justify a continued positive view. Secondaries will be traded at a more normal 10-15 per cent discount.

**Private equity**

**POSITIVE.** The global recovery, QE2 and poor weather conditions drove up commodity prices in the last quarter of 2010. During 2011, the stabilised economic picture in both emerging market (EM) and developed market (DM) countries points towards continued upturns in this asset class.

**Currencies**

**NEUTRAL/NEGATIVE.** This year should be dominated by trends, risk appetite and interest rate differentials. The carry trade should comprise a strong component for EM currencies, which are expected to strengthen against DM currencies as risk appetite increases.

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*This opinion refers to the alpha-generating capacity of a foreign exchange trading manager.*

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**EXPECTED RISK AND RETURN (1-2 YEAR HORIZON, ANNUAL AVERAGES)**

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**HISTORICAL RISK AND RETURN**

(FEBRUARY 28, 2001 TO JANUARY 31, 2011)

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**HISTORICAL CORRELATION**

(FEBRUARY 28, 2001 TO JANUARY 31, 2011)

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Historical values are based on the following indices: Equities = MSCI AC World, Fixed income = JP Morgan Global GBI Hedge, Hedge funds = HFRX Global Hedge Fund, Real estate = SEB PB Real Estate, Private Equity = LPX50, Commodities = DJ UBS Commodities TR, Currencies = BarclayHedge Currency Trader.
Will history repeat itself? The world’s stock markets may yield positive surprises.

2011 – an investment odyssey: The differences between markets are increasing.

Broader base will allow new stock market heights: More broad-based growth will broaden business opportunities.

**THEME: LARGE OUTFLOWS FROM THE EM SPHERE**

Emerging markets were the great favourite of investors last year. So far in 2011, however, capital has flowed out of the EM sphere. The reason is greater concern about inflation in most EM countries, plus surprisingly positive growth in the US, Germany and Sweden.

Source: EPFR Global

**THEME: TO DATE, STOCK MARKET HISTORY HAS BEEN A VERY GOOD GUIDE**

Since early 2009, the global stock market (the MSCI in local currencies, brown line) has shadowed the S&P 500 – the “guide” (green line) – for 2003-2004. Both 2003 and 2009 were characterised by strong stock market rallies after turnarounds in the spring, while 2004 and 2010 were dominated by more sideways price movements in the framework of “range trading”. The question now is whether during 2011 the global stock market will shadow the 2005 performance of the S&P 500.
Portfolio strategy

Portfolio strategy

MODERN PROTECTION
Rising 10-year bond yields seem to be the trend that has crystallised most clearly since the last Investment Outlook in December 2010. Around the end of September, the falling trend for American long-term yields reversed. German 10-year yields had begun their upward movement one month earlier, and during the fourth quarter they climbed from 2.2 per cent to 2.95 per cent and then continued during January to more than 3.2 per cent.

One whole percentage point must be described as a relatively sharp movement as well as a definitive turnaround. Bond markets, too, have now apparently accepted forecasts that global economic conditions will improve, and that the risk of double dip recession and deflation have substantially diminished or completely disappeared. The market has become clearly less favourable for fixed income investments as worries about inflation have returned. This is especially true of China, which has raised key interest rate several times since October, but also other emerging market (EM) countries.

Our cautious attitude towards government bonds with long maturities has been rewarded to the extent that we have not followed the bond market downward. The JPMorgan Government Bond Eur index fell 3.6 per cent during the period November to January, while Modern Protection remained essentially unchanged during the same period (after management expenses).

Unfortunately, short-term fixed income investments do not provide enough absolute return to enable us to achieve our targeted return of risk-free interest plus 1-2 per cent without duration risk. We have made adjustments in the portfolio that better adapt the return profile to prevailing market conditions. We have increased active risk in corporate bonds with the help of a new, short-duration High Yield holding that we expect to deliver 5-6 per cent annually. We have also increased the share of “absolute/total return” funds in the portfolio, added a completely market-neutral investment related to equity funds and adjusted our hedge fund holdings upward with low-risk funds. The risk in the portfolio will remain around 1 per cent, which is somewhat low during a normal economic recovery. There is still room for us to look for sources of returns without jeopardising our capital-protecting investment profile.

Portfolios for a new cyclical phase

Our portfolios are positioned for the new phase of the economic cycle, with a stronger and broader upswing in the OECD countries. For Modern Growth and Modern Aggressive, this will mean less dramatic contrasts between emerging markets and industrialised countries, and for Modern Protection a larger share of High Yield and absolute return investments.

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MODERN GROWTH

Last autumn’s strong performance for risk assets largely lasted until December, with a minor correction during November. During January, however, renewed worries about sovereign debt on the periphery of Europe, coupled with rising inflation in emerging markets, left their mark.

In keeping with our view of the market, we increased the risk asset allocation in the Modern Growth portfolio during the fourth quarter, which has been beneficial. In the equities sub-portfolio, we saw that mature markets were doing better than emerging markets. Our global managers have continued to perform above index, while emerging market managers have faced more headwinds. While emerging markets had a strong 2010, we are seeing more and more signals that 2011 will be a year of revenge for mature markets, and we intend to adjust our allocation in the equities sub-portfolio accordingly.

February has begun strongly, and we are thus choosing to buy into the stock market gradually, resulting in a somewhat larger cash position at the moment.

While private equity, like the stock market, was affected by macroeconomic worries during January, commodities have not seen equally steep downturns. Oil prices have moved above USD 100 per barrel, and agricultural commodities have continued to climb after disruptions in production due to weather-related factors. Both asset classes nevertheless showed upturns of more than 12 per cent during the November-January period. In private equity, we are seeing discounts to net asset value (NAV) shrinking but they are at attractive levels, while NAV has successively appreciated. Activity among large companies with surplus liquidity is increasing, with more acquisitions of companies as a consequence, which also benefits private equity company valuations. Bank lending is also increasing, which means that financing opportunities are improving for private equity companies. In keeping with our view that the global recovery will continue during 2011, we are increasing our private equity allocation in Modern Growth to 5 per cent.

In the fixed income sub-portfolio, since last autumn we have moved out of the Investment Grade segment in order to focus on High Yield, emerging market bonds and convertible bonds. While European and American sovereign yields rose during November-January, resulting in a decline of more than 2 per cent in global government bonds, our fixed income sub-portfolio contributed positively. Due to continued attractive yield spreads between High Yield and government bonds, high coupons and potential exchange rate gains on emerging market bonds, plus attractive risk-adjusted potential returns from convertible bonds, we will continue to focus on these segments.

The task of changing our hedge fund sub-portfolio has continued during the autumn and winter, which has begun to show results. Using Event Driven, CTA (systematic diversified, using computer models), Global Macro and Multi Strategy, our hedge fund sub-portfolio is aiming towards a market situation of gradually normalising trends, continued global tensions between emerging markets (EM) and developed markets (DM) plus increased activity at the microeconomic level, for example in the form of corporate buy-outs. We choose our hedge fund managers with care. Some of these managers have chosen to close their funds to new investments, which we view as a sign of health – an excessively large fund is difficult to manage and hurts potential returns. This does not affect fund liquidity, however, and we are continuing to monitor the liquidity risk in our hedge fund sub-portfolio.

Foreign exchange markets have remained difficult to interpret, but we expect EM currencies to continue appreciating, driven by both fundamentals and interest rate spreads. The risk level in our currency holdings is low. This is also reflected in returns, which were slightly negative in November-January. We have now begun an analysis of how we can take better advantage of the potential in the trends we foresee in the foreign exchange market. One probable result is that we will implement a new currency strategy aimed at emerging market currencies. However, the nature of this strategy and its interplay with the total portfolio must be further analysed before we can draw any conclusions.

Overall, we foresee that our Modern Growth strategy will continue to follow upturns, while our diversification among and between asset classes will be favourable in downturns. Our fundamental strategy will continue to be to position the portfolio towards global recovery.
Portfolio strategy

MODERN AGGRESSIVE
In Modern Aggressive, we invest in those asset classes and segments where we foresee the greatest risk-adjusted potential returns, without sacrificing our broad diversification philosophy. In keeping with our view of the market, during the fourth quarter we increased our allocation to risk assets, which has been beneficial.

In the equities portfolio, we saw that mature markets were doing better than emerging markets. Our global managers have continued to perform above index, while emerging market managers have not been as fortunate. About 40 per cent of the equity holdings in Modern Aggressive consists of emerging markets, and about 60 per cent consists of global equities, which means that our allocation has made a negative contribution compared to global equities indices since the last Investment Outlook. For the full year 2010, however, our allocation to EM equities was clearly beneficial, with the equities sub-portfolio performing about 2 percentage points better than the MCSI AC World Net index, measured in euros.

While emerging markets had a strong 2010, we are seeing more and more signals that 2011 will be a year when mature markets bounce back, and the inflation risk in major EM countries is increasingly evident. Looking ahead, our strategy is to allocate away from “core EM”, such as the BRIC countries, partly in favour of mature markets (the US, Europe). Meanwhile we are studying the possibility of investing in “frontier markets” – less developed EM countries – where we foresee rising potential. February began strongly. We are thus choosing to buy into the stock market gradually, resulting in a somewhat larger cash position at the moment.

Private equity, like the stock market, was affected by macro-economic worries during January, while commodities have not seen equally steep downturns. Oil prices have moved above USD 100 per barrel, and agricultural commodities have continued to climb after disruptions in production due to weather-related factors. Both asset classes nevertheless showed up-turns of more than 12 per cent during the November-January period. In private equity, we are seeing the discount to net asset value (NAV) shrinking but still at attractive levels, while NAV has successively appreciated. Financing opportunities have also improved for private equity companies as bank lending has increased. Activity among large companies with surplus liquidity is increasing, with more acquisitions of companies as a consequence, which also benefits private equity company valuations. Our private equity allocation in Modern Aggressive is currently more than 10 per cent, which we regard as a comfortable level, given the risk and return targets of the total portfolio.

In the fixed income sub-portfolio, we sold off our convertible bonds in order to focus entirely on High Yield and emerging market bonds. In a climate where the prices of convertible bonds have normalised, convertibles seem more like an equities exposure with downside protection. In Modern Aggressive, we have thus chosen to seek out the underlying equities risk. While European and US sovereign yields rose during November-January, resulting in a decline of more than 2 per cent in global government bonds, our fixed income sub-portfolio contributed positively to our returns. Based on continued attractive yield spreads between High Yield and government bonds, high coupons and potential exchange rate gains on EM bonds, we will continue to focus on these segments.

We have begun to see results from the task of changing our hedge fund sub-portfolio, which has been under way during the autumn and winter. Using Event Driven, CTA, Global Macro and MultiStrategy, the hedge fund sub-portfolio is aiming at a market situation of gradually normalising trends, continued global tensions between emerging markets (EM) and developed markets (DM) plus increased activity at the micro-economic level, for example in the form of corporate buy-outs. We choose our hedge fund managers with care. Some of these managers have chosen to close their funds to new investments, which we view as a sign of health – an excessively large fund is difficult to manage and hurts potential returns. This does not affect fund liquidity, however, and we are continuing to monitor the liquidity risk in our hedge fund sub-portfolio.

Modern Aggressive currently has no holdings in the currencies asset class. To improve the diversification characteristics of the portfolio, we are studying the possibility of implementing a new currency strategy with sufficiently high potential returns, while contributing to lower total risk for the portfolio. In real estate, we will continue to see centrally located premises generating returns, but from a portfolio standpoint we will focus more on properties with higher potential returns. However, the real estate market has continued imbalances in the high-risk segment and we are still holding off on real estate investments.

Overall, Modern Aggressive has delivered attractive returns in relation to total risk, and we expect this to continue. Our fundamental strategy will continue to be to position the portfolio towards global recovery and, in each asset class, to find the most attractive risk-adjusted returns.
**Theme:**
Will history repeat itself?

Stock markets may be better than history indicates

- Historical patterns have repeated themselves in MSCI World
- Good conditions for upside surprises in 2011 supported by...
- ...better economic momentum as well as low inflation and continued stimulus in the OECD

Sometimes history can be an outstanding guide to the future in the economic and financial world. One example of this is how well the performance of the S&P 500, an American stock market index, during the years 2003-2004 matches the path of the global stock market (the MSCI World index in local currencies) during the years 2009-2010. The correlation has been amazingly high. See the chart below.

So one question that naturally arises is whether the performance of the S&P 500 during 2005 may be an equally good guide to what will happen to the global stock market in 2011. During 2005, this US stock index rose by less than 5 per cent, and the question is thus whether the global stock market will show an upturn of the same magnitude during 2011, or whether there is reason to expect it to perform better or worse than this.

To be able to respond to this question, the economic and financial conditions during 2005 must be compared to those during 2011 (according to SEB’s forecasts). This applies especially to the economic cycle and its trends, inflation and commodity prices, what happens in the fixed income market and in economic policy, as well as profits and valuations.

The first global recession of the new millennium bottomed out in the spring of 2003 and was followed by a customary recovery. After a global GDP increase of more than 2.5 per cent in 2003, growth accelerated to more than 4.5 per cent in 2004 (see the table on the next page). The emerging markets (EM) sphere led the world economic recovery, with a growth rate substantially higher than in the OECD industrialised countries.

Better global economic profile now than in 2005
In 2005 several major OECD economies lost some of their dynamism, as reflected in slower GDP growth than during 2004. This was especially true of the United Kingdom and Japan,
but the United States and the euro zone also lost momentum. Meanwhile both the Chinese economy and – not least – the Indian economy grew faster, while other parts of the EM sphere were characterised by a slight deceleration.

During the first half of 2005, economic conditions weakened mainly in the OECD – the growth rate slowed – due among other things to a significant swing in the inventory cycle in the US, Asia and Europe from earlier large inventory build-up, to smaller build-up, to draw-down. A sharp oil price upturn also contributed to the deceleration. But in the summer various signals of global economic revitalisation emerged. In the US, however, this encountered a temporary setback during the late summer due to the ravages of Hurricane Katrina. Around the end of 2005, global economic conditions strengthened on a fairly broad front.

![GDP Growth Chart](chart)

Our forecast for 2011 shows slightly lower world GDP growth than in 2010, a pattern similar to that of 2004-2005. But unlike then, we now predict that the OECD economies will speed up somewhat, primarily due to acceleration in the US economy, but also in the Nordic countries and the euro zone. In the EM sphere, the expansion in both Asia and Latin America will slow, while Eastern Europe will pick up more speed.

So while the economy thus weakened in the first half of 2005, today there are many indications of an economic expansion at least during the first half of 2011: the J.P. Morgan global purchasing managers’ index has climbed significantly since October 2010, the American ISM purchasing managers’ indices for both manufacturing and services are pointing steeply upward, the IFO business sentiment index in Germany has reached a record level since reunification in 1990 etc. The list of current strong expansion signals can easily be made longer.

The negative inventory effect that characterised the spring of 2005 occurred at an earlier stage of the current economic cycle – in the US during the fourth quarter of 2010. This meant a sharply lower inventory build-up compared with the preceding period, a factor that “stole” no less than 3.7 percentage points from GDP. Yet the American economy managed to grow by 3.2 per cent during the quarter, thanks to substantially larger final demand – in itself a sign of strength.

Unlike 2005, when American household saving was close to zero, it is now larger than usual. Together with large savings in the corporate sector as well, this promises higher demand in the form of private consumption and capital spending.

Lingering pessimism among households and reversals in the housing sector are however two flies in the economic ointment.

**Conclusion:** The momentum of the economy – especially in parts of the OECD countries – is significantly stronger in early 2011 than at the beginning of 2005.

**Fewer inflation problems in OECD, more in EM sphere**

Good economic growth and low inflation are a combination that the stock market usually likes. Since the early 1980s the inflation rate in the OECD countries has also tended downward, among other things due to a strong focus by many central banks on inflation-fighting as well as keener international competition due to globalisation and new technology.

Early 2005 was characterised by somewhat faster OECD consumer price increases, especially because of sharply rising oil prices, which also made petrol more expensive. But with the exception of industrial metals, whose prices likewise rose significantly, most other commodities showed a rather sedate trend in 2005. Cost pressure measured as unit labour costs was also low, and core inflation (excluding food and energy) was quite modest: about 2 per cent in the US and only 1.5 per cent in the euro zone. In the BRIC countries (Brazil, Russia, India and China), inflation was indeed relatively high in 2005, but the rate declined in the course of the year.

Compared to 2005, inflation in the EM sphere – mainly in Asia and Latin America – is likely to be a bigger problem in 2011. Underlying it is rapid economic growth, increasing shortages of production factors – no more output gap – as well as more expensive commodities, recently food in particular.

### BIGGER INFLATION PROBLEMS THIS TIME

In 2005 the inflation rate in the BRIC countries trended downward, while today the rate is about to increase – a direction likely to dominate the next few quarters. In the EM sphere as a whole, consumer price inflation this year may end up close to 6 per cent, compared to a bit above 5.5 per cent last year.
The ravages of the La Niña weather phenomenon have boosted international food prices by nearly 90 per cent since last summer. Even if the weather situation stabilises this spring, there will be a large impact on the consumer price index (CPI) in EM countries during the first half. In many countries, food accounts for 25-30 per cent of CPI; in Russia and China the weighting is above 30 per cent, and in the Philippines nearly 50 per cent.

The situation is different in the OECD countries. While total consumer prices are rising more today than last summer, core inflation remains very low: between 0.5 and 1 per cent in both the US and Europe. The level of idle production capacity (the output gap) is also historically large according to the OECD’s calculations, about 4-5 times larger than in 2005. This means the economies of the industrialised countries can grow rapidly for a long period without price pressure as a result of capacity shortages.

Conclusion: It will be a long time before inflation becomes a problem in the OECD countries, while it is already a problem in Asia excluding Japan and in Latin America.

Policies good for OECD shares, bad for EM ones
During 2005, several central banks had begun key interest rate hikes in response to the economic upturn and in order to prevent higher inflation later on. In the OECD countries, the Bank of England (BoE) took the lead – its first rate hike came as early as autumn 2003. Due to a clear weakening in the British economy, sharply slowing home price increases and inflation at the 2 per cent target, a key rate cut came as early as August 2005. While the British economic cycle had already peaked, other economies had some distance left. The US Federal Reserve (Fed) began its rate hiking cycle in mid-2004, and during 2005 the federal funds rate rose from 2.25 to 4.25 per cent. Late in 2005 the European Central Bank (ECB) raised its refi rate for the first time to 2.25 per cent, while the Bank of Japan (BoJ) left its key rate at around zero throughout 2005.

In light of near-zero inflation in Sweden, the Riksbank cut its repo rate to 1.5 per cent in the summer of 2005.

Monetary tightening also occurred during 2005 among the BRIC countries. The most forceful was Brazil’s central bank, which hiked its key rate from 17.5 to 20 per cent during the first half, then lowered it in several stages late in the year. India raised its key rate in late 2005, to 6.25 per cent, while the People’s Bank of China (PBOC) did not touch its key interest rate (5.5 per cent) but tightened policy via greater restrictions on bank lending. China also tightened fiscal policy by trimming government spending and raising energy taxes. The Russian central bank left its key rate at 13 per cent throughout 2005.

During the recent financial and economic crisis – which culminated early in 2009 – central banks worldwide dramatically slashed their key interest rates. Several of them also launched quantitative easing (mainly bond purchases) as an element of monetary policy. In the OECD countries, the ultra-loose monetary policies of the major central banks remain in place early in 2011, with key interest rates of zero to 1 per cent. Judging from SEB’s forecasts, the first key rate hikes will not occur until this coming autumn (ECB) and winter (BoE), while the Fed and the BoJ will hold off significantly longer (until Q2 and Q3, 2012, respectively). However, a number of central banks in somewhat smaller OECD countries – among them Sweden’s Riksbank – have already begun their rate hiking cycles.

In the US and elsewhere, a combination of historically low key interest rates and recently rising government bond yields has meant that the yield curve – created by charting the yields on fixed income securities with different maturities – has assumed a historically steep angle. The difference between a 10-year Treasury bond yield and the US federal funds rate is nearly 3.5 percentage points today, compared to 2 percentage points early in 2005.

Theme: Will history repeat itself?

The Federal Reserve’s key interest rate is likely to remain at a record-low 0-0.25 per cent for another year. In Sweden, however, high growth and increased inflation justify continued repo rate hikes during 2011. Except in Russia, BRIC country central banks have started hiking rates. They will stick to this path in 2011. Russia is soon likely to follow suit.
A steep positive yield curve is usually regarded as a positive economic sign, and such a curve also benefits the banking system.

As for yields on government bonds, the picture was a bit mixed during 2005 – they rose somewhat in the US after a long period of sideways movement (despite the Fed’s key interest rate hikes, which former Fed Chairman Alan Greenspan described as a “conundrum” (a mystery)). They were unchanged in Japan and fell in the euro zone, whereas today’s assessment is that there will be a broader upturn in government bond yields during 2011, though a rather gentle one. Yields are nevertheless lower in early 2011 than at the beginning of 2005.

Looking ahead, one reason behind the probable rise in government bond yields will be the financing of large budget deficits in the wake of the financial and economic crisis. Most countries have begun or are planning steps to trim their government deficits, but there are also exceptions, notably Japan and the US. In the latter case, President Barack Obama’s new stimulus package, which includes further tax cuts, will cause the federal budget deficit to grow from nearly USD 1.3 trillion last year to more than USD 1.5 trillion during 2011. Such loose fiscal policy had no equivalent in 2005; President George W. Bush began his second term of office with budget tightening measures.

Due to mounting inflation risks in parts of the EM sphere, central banks in China, India, Brazil and elsewhere began their tightening processes as far back as one year ago. This time around, too, the Brazilian central bank used its interest rate weapon the most aggressively. India’s key interest rate has also escalated substantially in the past year. The first Chinese key rate hike came in October 2010 and the third was delivered in early February, but before that the PBOC had raised reserve requirements for banks in several steps and taken other action to limit their lending. During 2011 interest rate hikes in the EM sphere appear likely to be both more numerous and in many cases larger than during 2005.

**Conclusion:** Monetary policy in major OECD countries will remain a positive stock market factor during most of 2011. Steep yield curves as well as fiscal policies in the US and Japan will also provide support. In these respects, conditions are much more favourable than they were during 2005.

**HARDER TO LEND MONEY IN CHINA**

In January 2010 China’s central bank raised bank cash reserve requirements for the first time. Since then, it has done so many more times. Its purpose is to limit bank lending in order to cool down the economy and reduce the risk of serious speculative bubbles.

**NEW AMERICAN STIMULUS PACKAGE**

Unlike most other OECD countries, the US under President Barack Obama is launching another fiscal stimulus package. But in 2005, when George W. Bush began his second term, he tightened fiscal policy. The chart shows the US federal budget balance.
In the EM sphere, interest rates will be raised on a rather broad front during 2011, which would appear to be negative for the stock market in the short term. But judging from historical experience – for example the US in late 2005 and early 2006 – the stock market can climb during the latter part of a rate hiking cycle, in the same way that the stock market often enters a more hesitant phase for a period before the first rate hike occurs.

**Good profit outlook and attractive valuations now**

A comparison between profit forecasts and valuations early in 2005 and those early in 2011, for example in the US and Sweden, shows that key ratios in both cases are more favourable now than at that time. Early in 2005, profits in a 12-month perspective were forecasted to increase by 10 per cent in both the US and Sweden; today the corresponding figures are 13.7 and 12.5 per cent, respectively.

As for valuations, early in 2005 the US stock market (S&P 500) was trading at a price/earnings ratio of 17 based on profit estimates looking ahead 12 months, compared to 13.5 today. The corresponding figures for the OMX Stockholm exchange are 14.6 and 13.1, respectively.

Elsewhere in the stock market world, there are also attractive key ratios today; P/E ratios are in the 10.5 (euro zone) to 14.0 (Japan) interval, and forecasted profit increases range from 24 (Japan) to 12.5 per cent (Sweden and the euro zone). EM stock exchanges as a whole are characterised by rather low valuations (P/E ratio 11.5) and a decent profit outlook (15.5 per cent increase).

**Conclusion:** Both in a general historical comparison, and compared specifically to conditions early in 2005, the profit outlook in 2011 appears good and valuations look attractive.

**The last word:**

Weighing together all the pluses and minuses related to stock market conditions in 2005 and 2011 leads us to the observation that the world stock market – which has very closely shadowed the American S&P 500 index during 2009-2010 – has a chance of providing upside surprises during 2011, that is, by climbing more than 5 per cent. The potential seems greatest in the OECD countries, and the risks seem greater in parts of the EM sphere.

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**GLOBAL ECONOMY ON ITS WAY TOWARDS SPEEDING UP**

On the threshold of 2005, the world economy as measured by the J.P. Morgan global purchasing managers’ index was characterised by a slowdown, and the same signals were coming from the US and China. On the threshold of 2011 the situation is different; the global economy is accelerating. But while the economic pulse in the US has speeded up significantly since last autumn, it has stabilised in China. This closely matches our 2011 forecast, which shows accelerating growth in the OECD industrialised countries and a slowing rate of growth in the emerging markets sphere.
US and Russia shine in new stock market model

• GDP change and monetary policy strong driving forces
• Important to distinguish between markets
• Position in the economic cycle determines rules of the game

The global economy has gone through a couple of very eventful years, with investors and analysts alternating repeatedly between hope and desperation. At times the outlook has been anything but clear. Central bank governors and finance ministers have had to navigate through unknown terrain in an effort to avoid a double dip recession and a deflation scenario. During other periods, market optimism has surged, especially as a consequence of the unprecedented stimulus measures that were launched on a broad front.

Although asset prices have been rising, it has been a bumpy ride due to dramatic fluctuations in risk appetite. Investors have either floored the accelerator or put both feet on the brake: pronounced risk-on/risk-off trading behaviour. Two main patterns have dominated. During periods when there has been a high level of willingness to take risks, investors have bought equities, corporate bonds and commodities on a broad front while selling government bonds and US dollars (so-called reflation trade). And when risk appetite has been low and the focus has been on the deflation scenario, investors have done the opposite (so-called deflation trade).

The search for quality a theme in 2010

However, some equity strategies have been more favourable than others. In the March 2010 issue of Investment Outlook, we argued that quality should be the guiding principle for investors. This theme dominated asset prices during much of 2010. There was great interest in countries with sound finances and current account surpluses, and asset classes connected to these countries attracted greater demand. The stock exchanges in the Nordic countries, Germany and most emerging market (EM) countries thus performed better than those in southern Europe, the US and Japan. Meanwhile, flows from developed market (DM) countries to the EM sphere were massive. Aside from stable finances, higher growth attracted investors to the EM sphere, which steamed ahead with almost uninterrupted strength despite the financial crisis.

LARGE OUTFLOWS FROM THE EM SPHERE

Emerging markets were the great favourite of investors last year. So far in 2011, however, capital has flowed out of the EM sphere. The reason is greater concern about inflation in most EM countries, plus surprisingly positive growth e.g. in the US, Germany and Sweden.
Shifting market trends

Developments since the turn of the year indicate that various correlations that applied earlier are fading. So far during 2011, for example, there has been an unusually large discrepancy between the returns on shares in different stock markets. During January there was a gap of about 30 per cent between the best- and worst-performing stock markets. This indicates that investors are no longer as uniformly positive or negative towards risk assets, but their investment decisions are instead based to a larger extent on the conditions in individual markets. The negative correlation that has existed between the US dollar and risk assets also seems to have loosened. Despite uncertain risk appetite, the dollar has continued to lose ground since New Year – even though the American economy has been in good shape recently.

Last year’s massive flows from DM countries to most EM countries have also shifted direction. The economic wheels are spinning too fast in most EM countries, as expressed by sharply rising real estate prices and accelerating inflation. Above all, massive increases in food prices have driven up inflation. Generally speaking, food accounts for a significant percentage of the consumer price index (CPI) in EM countries. To cool down the economy and regain control over runaway inflation, central banks are being forced to carry out monetary tightening, which investors have not appreciated. In addition, there have been substantial positive growth surprises in North America, Germany and Sweden, so investors no longer need to turn to the EM sphere to gain exposure to growth.

More important to distinguish between markets

It is still too early to draw major, far-reaching conclusions about the market trends that have emerged recently. The market can quickly change focus. If inflation worries are overcome, for example, monetary flows may again shift back towards the EM countries. But one thing that we believe is here to stay is that it will be increasingly important for investors to distinguish between different markets. Conditions today are highly varied, mainly depending on where a country is in the economic cycle. It requires a more stringent analytical approach at the country level to try to find the most attractive investment alternatives.

For this purpose, we have selected six factors we believe are of particular importance and that, at present, have the potential to drive share prices from a country perspective. These are the level of GDP growth, the change in GDP growth, monetary policy, financial stability, share valuations and currency. We score each factor based on its positive or negative contribution to the stock market in each respective country. The scale runs from -3 to +3. We have also chosen to weight these various factors on the basis of how large an impact we believe they will have in the market climate we foresee (see the matrix below). This model is a tool for structuring markets and finding the driving forces of tomorrow, although due to the limited selection of criteria, it will not always fully capture all forces and scenarios. The model is consequently not an absolute truth, but is intended to describe how we view the market and what we believe will drive it.

High GDP growth was a driving factor during much of last year and something that partly explains the surplus returns in many EM countries. But historically, the connection between GDP growth and share prices has been fairly weak. China and Brazil are a good example. China is a growth engine that has boasted annual GDP increases of nearly 10 per cent since 1994, while Brazil’s annual GDP growth has only reached 3 per cent during the same period. Although China wins hands down in the growth league, the Brazilian stock market has performed significantly more strongly during this period. The growth gap between DM and EM countries is now also shrinking, since the US and large parts of Europe have progressed further in their economic recovery.

**OUR REGIONAL ASSESSMENT MODEL**

<table>
<thead>
<tr>
<th>Country/region</th>
<th>GDP growth</th>
<th>Change, GDP growth</th>
<th>Monetary policy</th>
<th>Financial stability</th>
<th>Valuations</th>
<th>Currency movements</th>
<th>Total</th>
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<td>2</td>
<td>5</td>
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</tr>
<tr>
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<td>1.5</td>
<td>0.5</td>
<td>1</td>
<td>1</td>
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</tr>
</tbody>
</table>

* The weighting we have chosen for a factor is multiplied by the score for each country/region. Then the total score for each country/region is added up.
Although the weighting of high GDP growth is likely to diminish, it is nevertheless a parameter that will be taken into account when investors choose their share allocation, which contributes positively to most EM stock markets in particular. Year after year of high growth also carries broader implications. Growing economic and political influence improve a country’s negotiating opportunities. They also strengthen that country as an alternative on the investment map. In addition, today it is difficult to grasp the full impact of the rapidly growing middle class especially in China and India, but this is certain to stimulate economic activity in a long-term perspective. We have chosen to multiply the score that countries receive for GDP growth by 0.5.

**Change more important than speed**

**Changes in GDP growth** are a factor that is likely to have a major impact on share prices, especially if these changes are unexpected. For example, the acceleration in the Swedish, German and American economies has had a clear effect on the stock markets of these countries in recent months. DM countries are likely to have greater potential than EM countries to provide upside surprises, since they are starting from lower GDP growth rates and are in an earlier stage of the economic cycle. We are multiplying the score for this factor by 1.5.

**Monetary policy** in different countries is likely to be of central importance, since the economic pulse differs significantly between regions. In China, Brazil and India, the central bank’s ambition is to cool down economic activity, ease inflation pressure and slow price upturns on sometimes runaway asset prices. In the US and Japan, however, we expect central banks to continue pursuing ultra-loose monetary policies. Their objective is to stimulate economic activity, and rising asset prices are welcome. For investors, an expansionary monetary policy is preferable, especially when there is an opportunity to choose. We are multiplying the score for this factor by 1.5.

**Financial stability** was the main guide in carrying out a regional portfolio allocation in 2010. As the recovery progresses, however, there is likely to be less and less focus on this factor – among other things because higher GDP growth in itself often leads to more stable finances as unemployment falls and tax revenue rises. But the major debt consolidation process that most DM countries are facing may lower their GDP growth by a percentage point or so. The situation in southern Europe remains acute and is likely to emerge as a source of concern from time to time. But debt problems are already largely priced into the stock market, and the situation has generally improved. The US, Japan and the UK also suffer from weak finances, to say the least, but these countries should be able to avoid close market scrutiny, in any case during 2011. We are multiplying the score for this factor by 0.5.

**Attractive valuations**

Due to upward revisions in profit expectations, share valuations (expressed as price/earning ratios) have fallen in the past year even though most stock markets have two good years behind them. Generally speaking, valuations are at relatively attractive levels today. Some markets stand out as especially favourable, and these are Russia (which is traditionally traded at unjustifiably low P/E ratios) as well as China, Eastern Europe and southern Europe (which has shown weak stock market performance for a long time). Valuations are always of central importance for equity investments, but no special weighting of this factor is needed at present.

**Currency movements** are a variable with several dimensions from an investor standpoint. Among other things, a weak currency may be positive for the stock market, since it strengthens the competitiveness of a country’s export sector. However, in many cases today’s listed companies are so globalised that it is difficult to know where their production costs and sales are located. In our model, we have instead taken into account the direct effect on returns for an investor who buys foreign equities. A stronger currency thus contributes positively to the overall yield on shares, while a weaker currency contributes negatively. Nordic currencies, especially the Swedish krona, are likely to continue their upward trend in 2011. Since the Chinese authorities are likely to step up the appreciation rate of the yuan, exposure to China should also be a good investment from a currency standpoint. Currency movements are always an important component in investment decisions and need no special weighting as a consequence of the market climate we foresee.

**Bright US outlook**

The US receives the highest score in our model. This is primarily due to our expectation that the Federal Reserve (Fed) will continue to pursue a highly expansionary monetary policy, plus our assumption that American economic growth will accelerate during 2011 as well as 2012. Changes in GDP growth as well as monetary policy are also the factors that, in our judgement, will have the greatest impact on share prices in the near future, and these have thus been given extra weight in the model. In addition, we believe that investors can allow themselves an exposure to the dollar, since the decline in the dollar has already been under way for some time and the US currency is undervalued today against most other currencies. The dollar should soon bottom out, and the risk of losing returns due to currency has diminished. In addition, the recent weakness of the dollar is likely to stimulate the US export sector, an assumption that nevertheless lies outside the scoring system in our model.

Russia qualifies as the most attractive EM country in the model, taking second place right behind the US. Strong, accelerating GDP growth and attractive valuations are what will lift
Russia. Historically, the price trend in the Russian stock market also closely correlates with the oil price trend. The recent unrest in North Africa has pushed oil prices above USD 100 per barrel, benefiting an oil-heavy stock market like that of Russia. This parameter lies outside our model, but makes Russia look even more attractive.

Riksbank pulls down Sweden
The Nordic countries are characterised by strong finances and a growth rate that currently stands out among the DM countries. The strength of the Nordic economies received extensive publicity at this year’s Davos meeting of the World Economic Forum, where the Nordics were praised for their crisis management and competitiveness (which is top-ranked by the WEF’s Global Competitiveness Report). But central banks that are hiking their key interest rates risk spoiling the stock market mood, so the region’s total score nevertheless ends up behind the US and Russia. The Swedish krona has strengthened significantly in the past year, and we believe that this appreciation trend will continue. This is good for foreign investors, but the krona is beginning to reach the pain threshold for the important Swedish export sector. Yet the Nordic countries are sharing third place with Eastern Europe, which has the same score. Above all, a clear acceleration in GDP growth, sound finances and attractive valuations are likely to benefit stock markets in the region.

China ends up right in the middle among the countries we have chosen to examine closely in our model. China’s monetary policy is aimed at blunting inflation and the sharp rise in real estate prices, which pulls down its score. But if China succeeds in tightening exactly enough, without causing its economic growth to decline too far, the country looks very attractive from a stock market perspective. China without any risk of real estate bubbles or an inflation spiral would be genuinely interesting, especially since its stock market performance has lagged behind that of other countries for some time.

Germany is in a stage of the economic cycle similar to that of the US, yet ranks far lower in our model. One reason is that the ECB will tighten its monetary policy about six months before the Fed. We expect Germany’s economic growth to slow somewhat this year as well as in 2012, but the export sector should benefit from the currency situation, since the euro is undervaluedly weak due to the debt crisis in southern Europe.

Southern Europe may cause surprises
The lowest scores in the model go to Japan, Brazil and southern Europe. Japan greatly surprised everyone last year with its GDP growth of 4 per cent, but this year and in 2012 we predict that the rate will slow to 1.6 per cent. In addition, Japan is saddled with the world’s largest government debt as a percentage of GDP. There are many indications that the Japanese yen should fall from today’s high levels. But one positive factor for the Japanese stock market is that the Bank of Japan is likely to be the last central bank to begin its rate hiking cycle.

In the case of Brazil, the low score is primarily due to the monetary policy actions that have been taken to keep the Brazilian real from rising too far in value. By charging a 6 per cent exchange cost for fixed income securities and 2 per cent for equities, Brazilian authorities are trying to reduce the inflow from international investors. Meanwhile inflation is climbing in Brazil, which justifies the interest rate hikes. But high interest rates would further increase appreciation pressure on the currency. Brazil is thus in a difficult situation, and there are better and cheaper alternatives for investors wishing to gain exposure to EM countries or commodities.

Southern Europe receives weak scores on most factors in our model. GDP growth is low and is not expected to speed up. Financial stability is conspicuously missing. Meanwhile it is no secret that the region is on the brink of ruin, so the gloomy outlook should already be priced into equities. There is thus potential for sizeable price gains in case the situation improves. Since the beginning of 2011, the worst concerns about southern Europe have subsided. As a result, the Greek stock market has risen by 20 per cent, for example. However, investing in southern Europe is still something for the most daring: preferably with both a cool head and nerves of steel.

**EXPANSIONARY US MONETARY POLICY**

*There is a wide gap between borrowing cost and growth in the American economy. As a rule, this leads to increased economic activity and rising asset prices. An expansionary US monetary policy is likely to attract investors, since interest rates are being raised in many other parts of the world.*
Theme:

Broader base will allow new stock market heights

More driving forces for stock markets in 2011

- Broader global growth, with positive momentum in more regions
- Growth spreading to more sectors of the world economy
- New cyclical phase will generate more business opportunities

Stock market returns are usually expressed in terms of 8-10 per cent a year under favourable circumstances. This is also how we express expected return when optimising our portfolios. But concealed behind this figure are major differences at the sectoral level. Last year the difference between the best and worst sector was nearly 50 per cent both in the US and in Sweden. In other words, significant opportunities are being generated in the stock market and are well worth focusing on. In a year like 2011, once the big momentum shift to a growth cycle has been completed, it is important to have a more sophisticated approach to stock markets. In 2010, market return was sustained by growth in emerging markets and investments in the manufacturing sector. In 2011, a larger variety of driving forces will be in play.

We have a number of themes that are important to highlight:

Profits will rise during 2011 and 2012
Throughout the economic turnaround, corporate profits have been good. They have also climbed rapidly, in many cases to historically high levels. Cost savings and efficiency-raising measures have created a leveraging effect, now that demand is rising. Margins are already back at levels achieved before the economic downturn. Rising commodity prices may admittedly curb opportunities to raise margins further in some sectors, but corporate profit expectations are still being adjusted upward in many companies. Forecasts early in the year show a 12.5 per cent rate of increase in profits during 2011 in Sweden and just below 15 per cent in the US and the euro zone. In the case of Sweden, 2011 earnings per share are expected to surpass 2007 levels, thereby reaching an all time high. Forecasts for 2012 indicate a 12-13 per cent rate of increase in profits. Share price valuations are generally reasonable, even after last year’s stock market recovery.

![Growth in earnings per share](image)

**FORECASTS INDICATE CONTINUED STRONG GROWTH IN CORPORATE PROFITS**

After a strong recovery in 2010, profit forecasts for many companies are still being adjusted upward. Forecasts for 2011 and 2012 indicate annual global growth of around 15 per cent in earnings per share.

Source: Factset
More evenly distributed economic growth

We will see more evenly distributed growth in the world this year. The economic picture has gradually become brighter, and the recovery in the world economy will continue during 2011. World GDP growth is expected to be about 4-5 per cent this year. In the industrialised countries, growth is expected to be around 2-3 per cent, while emerging market growth will be substantially higher. The US and Europe are the regions with the greatest potential for positive growth surprises. The global growth trend is strong and has the potential to continue during 2012 as well. Overall, this means good stock market conditions during 2011. During this phase of the economic cycle, opportunities for good returns will broaden. The differences in returns between various sectors will narrow as the level of activity rises in more areas of the economy and as market players pay attention to sectors that have lagged behind.

DIFFERENCES IN RETURNS BY SECTOR WILL NARROW

There was a wide difference in returns from various economic sectors during 2010. Now that the level of activity is rising in more areas of the economy, the gaps between sectors are shrinking. The graph shows how this sector rotation began as far back as late November last year. (Trend of returns compared to the S&P 1200)

From this, new growth will emerge in terms of capital spending needs in the industrialised countries, and eventually higher consumer demand as employment prospects improve and consumer confidence rises. Now that the industrialised countries are about to enter a phase of higher growth and a build-up of domestic demand, household consumption will become very important. There are also sectors in these countries that are underinvested, for example household capital goods. In emerging markets, the economies are maturing and are in a later cyclical stage, which includes rising domestic consumption. More people are achieving a better financial situation, which in turn will generate rising demand and growing consumption around the world. In many cases, these are sectors where total demand is still below the levels from previous economic cycles. Among sectors that have not been high-performing in the past year, for example, are those that are driven by higher consumer demand. As employment and savings increase around the world, this picture will change and here we foresee a gradual upgrading of profit forecasts.

Monetary policy still stimulating many economies

Monetary policy is still providing an economic stimulus by means of low interest rates around the world, except in some Asian and emerging market countries where rising inflation has led to tightening measures. Bond yields will remain low – although there is a slight rising trend – and these levels are not a threat to stock markets, as long as yields are driven by stronger economic conditions and current inflation expectations. For the financial sectors of the economy, this is a good basic climate. Yield curves will be steep. This will lift the economy and help companies in the financial sector gradually achieve stronger balance sheets.

Commodities still favourable

The economic cycle is now entering a new phase. We are moving from a period when the driving forces have been growth in manufacturing sectors and the demand from emerging markets, towards a phase where growth spans more areas of the world and more sectors of the economy. In emerging markets, however, cyclical demand will remain strong and so will the need for commodities. Combined with a simultaneous growth improvement in traditional industrialised countries, we will probably see greater demand for industrial commodities and a need for higher production capacity. To oversimplify a bit, we can say that China has been the main force in driving the demand for commodities in recent years, but in the future they will have competition. This may mean solid demand in industries that deliver investment goods to mines. Here we have some of last year’s stock market winners, and after the decline in valuations that occurred early in 2011, such shares may be attractive again.

Late cyclical sectors will become more attractive

As mentioned, the focus has largely been on those sectors that perform positively at the beginning of the economic cycle, such as manufacturing and commodity companies. These companies may very well remain attractive in the future as well, but we will gradually see a shift in interest towards companies that have a late cyclical character. Their shares have performed relatively weakly, despite upward revisions in their profit forecasts. They include companies that produce investment goods – such as the heavy equipment group ABB – which are often dependent on public sector procurements and major projects that are often initiated at a late stage as the economic cycle has matured.

Rising dividends

Because of rapid recovery in corporate profits, combined with limited capital spending and few acquisitions and mergers, companies today have high liquidity. As a consequence, many companies will raise their dividends, as is already apparent
from year-end reports for 2010. Experience tells us that companies that meanwhile show good profit growth and high dividend capacity are good investments. Given today’s bond yield levels, equities with good dividends will seem like very good investments over the next couple of years.

More capital spending, acquisitions and mergers
Stronger demand, and deferred investment needs, will also lead to increased capital spending. This, in turn, will benefit companies that produce investment goods. There are many indications that companies will also continue to make efficiency-raising investments in order to keep their productivity high. Ample corporate cash reserves are also evident in an increase in mergers and acquisitions late last year. The trend toward more such transactions between companies will strengthen during 2011.

Falling risk premiums later in the economic cycle
In those European countries that have economic problems – mainly Portugal, Ireland, Greece and Spain – a large measure of financial risk remains, and risk premiums are high. Worries may flare up again during 2011, but the European Union is well prepared for this. The problems will mainly affect European banks, but these risks will gradually diminish if the current economic trend continues. Banks should thus be able to enter a new phase as risk appetite increases and the economy stabilises. The banking sector also generally benefits from growing economies and increased saving. This also means that various parts of the financial sectors will become more attractive as the economic cycle matures and credit demand increases.

Greater risk appetite and focus on equities
In our judgement, the world economy is at the beginning of a relatively long period of growth. Investors are still cautious, however, as reflected in today’s stock market valuations. As global growth increases, risk appetite will also increase. Among other things, this will lead to a reversal of the previous flows from equity investments into fixed income investments. This may provide a further tailwind for equity investments.
Macro summary

World economic growth is well above trend
Continued rapid expansion in the EM sphere
OECD inflation risks are exaggerated

The world economic outlook has improved. The US economy is gaining momentum, and the emerging market (EM) sphere is continuing to perform strongly. In Europe, however, the signals are more mixed: Germany and the Nordic countries are growing surprisingly fast, the British economy is hampered by fiscal tightening, and in southern Europe growth will be hurt by financial turmoil and tough budget consolidation. The global economy still faces a number of challenges in the form of a restructuring of the financial system, large and persistent financial imbalances, growing sovereign debts and still unresolved crises in a number of euro zone countries.

In spite of this, the world has entered a new economic phase, characterised by more self-sustaining growth. But worries about inflation have meanwhile increased in the wake of rising energy and food prices as well as tax increases in a number of countries. The inflation rate, especially in the OECD, may nevertheless fall a bit in 2011. Increases in commodity prices will probably slow, and unit labour costs are still falling thanks to good productivity along with low pay increases. But a bit further ahead, cyclical inflationary forces will strengthen.

Stronger, self-sustaining upswing in the US
The Federal Reserve’s ultra-loose monetary policy, together with new fiscal stimulus measures, is strengthening optimism in the US. Private saving has begun to decrease, which has usually meant that the economic upturn has become self-sustaining. Partly due to housing market setbacks and poor state government finances, however, the upturn will still be somewhat weaker than the historical average in the corresponding cyclical phase. SEB predicts that American GDP will increase by more than 3.5 per cent this year and by 4 per cent in 2012 – sizeable upward revisions compared to its November forecast. Large idle capacity in companies and in the labour market means that core inflation will remain low.

Germany: economic engine of the euro zone
GDP growth was unexpectedly high in the euro zone in 2010, mainly because Germany benefited from strong surges in exports and capital spending. The country will remain the strongest economic engine of the 17-nation currency union. Meanwhile continued weak growth in southern Europe will accentuate the euro zone’s two-speed economy. German GDP will increase by more than 3 per cent this year, but Greek GDP will fall by about the same percentage. Spain is hovering on the brink of recession. GDP in the euro zone as a whole will grow by a bit less than 2 per cent in both 2011 and 2012. Several of the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) carried out successful bond issues early in 2011, easing government fiscal worries somewhat, but their problems are far from resolved. The European Financial Stability Facility (EFSF) is thus likely to assume an expanded role.

Decent British growth in spite of everything
Severe snow storms in December caused British GDP to fall in the fourth quarter, a reversal that was probably temporary. Very loose monetary policy, a weak pound and strong international demand will sustain decent growth – despite sharp fiscal tightening, which will lower GDP growth by more than 1 percentage point in both 2011 and 2012. GDP is expected to grow by 1.5 per cent this year and 2.5 per cent in 2012.

Self-sustaining economic upswing

- World economic growth is well above trend
- Continued rapid expansion in the EM sphere
- OECD inflation risks are exaggerated

After slowing in the spring of 2010, GDP growth has accelerated in the United States, judging from many leading indicators.

In spite of this, the world has entered a new economic phase, characterised by more self-sustaining growth. But worries about inflation have meanwhile increased in the wake of rising energy and food prices as well as tax increases in a number of countries. The inflation rate, especially in the OECD, may nevertheless fall a bit in 2011. Increases in commodity prices will probably slow, and unit labour costs are still falling thanks to good productivity along with low pay increases. But a bit further ahead, cyclical inflationary forces will strengthen.

Stronger, self-sustaining upswing in the US
The Federal Reserve’s ultra-loose monetary policy, together with new fiscal stimulus measures, is strengthening optimism in the US. Private saving has begun to decrease, which has usually meant that the economic upturn has become self-sustaining. Partly due to housing market setbacks and poor state government finances, however, the upturn will still be somewhat weaker than the historical average in the corresponding cyclical phase. SEB predicts that American GDP will increase by more than 3.5 per cent this year and by 4 per cent in 2012 – sizeable upward revisions compared to its November forecast. Large idle capacity in companies and in the labour market means that core inflation will remain low.

Germany: economic engine of the euro zone
GDP growth was unexpectedly high in the euro zone in 2010, mainly because Germany benefited from strong surges in exports and capital spending. The country will remain the strongest economic engine of the 17-nation currency union. Meanwhile continued weak growth in southern Europe will accentuate the euro zone’s two-speed economy. German GDP will increase by more than 3 per cent this year, but Greek GDP will fall by about the same percentage. Spain is hovering on the brink of recession. GDP in the euro zone as a whole will grow by a bit less than 2 per cent in both 2011 and 2012. Several of the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) carried out successful bond issues early in 2011, easing government fiscal worries somewhat, but their problems are far from resolved. The European Financial Stability Facility (EFSF) is thus likely to assume an expanded role.

Decent British growth in spite of everything
Severe snow storms in December caused British GDP to fall in the fourth quarter, a reversal that was probably temporary. Very loose monetary policy, a weak pound and strong international demand will sustain decent growth – despite sharp fiscal tightening, which will lower GDP growth by more than 1 percentage point in both 2011 and 2012. GDP is expected to grow by 1.5 per cent this year and 2.5 per cent in 2012.
Inflation is well above the Bank of England’s 2 per cent target but is expected to begin slowing within a few months.

**Nordic countries – growth above European average**

The Nordic economies – especially Sweden – will continue to perform strongly. Their export industries are well positioned to respond to higher global demand for intermediate and investment goods. In addition, their public finances and current account balances are in very good shape. Sweden has the fastest-growing economy in the region, and it is expanding on a broad front. In Denmark and Finland the upswing is clearly export-driven, whereas shortages of production capacity have begun to slow Norwegian economic expansion.

**Japan losing momentum again**

A sharp upturn in exports and industrial production during the first half of 2010 lifted Japan’s GDP by nearly 4 per cent for the full year. But late in 2010 the upturn weakened significantly, and today many indicators – the purchasing managers’ index, consumer confidence, retail sales etc. – are pointing towards a weak 2011. GDP is expected to grow by a bit above 1.5 per cent in both 2011 and 2012. Consumer prices have recently shifted from declining to more or less stable and will remain so. Like the US, Japan has launched another fiscal stimulus package, but the government’s recent actions show a clear understanding of the need for budget tightening and tax reform. This was further fuelled by Standard & Poor’s downgrading of the country’s sovereign credit rating.

**Continued growth and inflation risks in Asia**

Asia excluding Japan will remain in the global front ranks in terms of growth. In China the GDP is expected to grow by 9.5 per cent this year and 8.5 per cent in 2012. The corresponding figures in India, the region’s second-largest economy, are 8.5 and 7.5 per cent. Partially due to their resilience during the financial crisis, Asia’s emerging economies are rather far ahead of the OECD countries in the economic cycle. One consequence is that inflation in the region has increased significantly. The main reasons for this are higher food and energy prices, but core inflation has also risen in such countries as China, India and Indonesia. Continued key interest rate hikes are thus in the cards for 2011. Differences in interest rates and growth prospects compared to the OECD countries make continued large capital inflows likely. This will put appreciation pressure on currencies and contribute to rising share and real estate prices, increasing the danger of asset bubbles.

**Latin America sharing second place**

Last year’s strong economic upswing in Latin America will now be followed by a slightly calmer growth rate, but with GDP rising about 4.5 per cent in 2011 and 2012, the region will share second place in the world economic growth league with Eastern Europe. Inflation – more than 6 per cent last year – may be a bit higher this year, and Brazil’s central bank will be among those continuing to hike key interest rates. Especially compared to the OECD countries, Latin America has consider-

**Global growth well above the historical trend**

We predict that GDP in the EM sphere as a whole – which accounts for nearly 50 per cent of the world economy (adjusted for purchasing power) – will increase by 6.5 per cent in both 2011 and 2012, while OECD growth will average less than 3 per cent. This means that average growth in the world economy as a whole will exceed 4.5 per cent per cent in 2011-2012, which is well above the historical trend.

**WHEELS OF GLOBAL INDUSTRY SPINNING FASTER**
The world’s stock markets generally performed positively during 2010, and the MSCI AC World Index in local currencies rose by 8.3 per cent, but it was quite a roller coaster ride. Stock markets declined early in the year, then there was a strong period in March and April, followed by great uncertainty during the spring and summer, including sharp price downturns. Worries about European government finances had hardly blown over when stock markets were hit by negative American macroeconomic statistics in August. The risk of a double dip recession in the United States seemed imminent. Optimism returned early in the autumn and the world’s stock exchanges have moved steadily upward since then, sustained by better macroeconomic statistics and positive company reports. The entire year’s upturn was created during the autumn, starting in October.

One global trend was that small companies performed significantly better than large companies. Another trend was that growth companies performed much more strongly than companies characterised by low valuations (value companies). US stock markets held their own, with an upturn of 13 per cent in local currency, while markets in Europe and Japan did significantly worse. European stock markets gained only 3.9 per cent, while the Japanese stock market index even fell somewhat.

Sweden ended up at the top among the world’s stock markets during 2010. Other exchanges that performed strongly were mainly in emerging markets: Peru, Thailand, Colombia and Chile. These small, slightly exotic stock markets returned between 30 and 50 per cent. The Philippines, Indonesia, South Korea, Malaysia and Russia were also among the winners. Equities in emerging markets as a whole indeed performed somewhat better than the world index in 2010, but during the autumn the trend shifted. These markets, which have performed significantly better than more mature markets for several years, began lagging behind. Instead the US, Japan and Europe took over as stock market engines.

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**Attractive valuations in a historical perspective**

- A more synchronised global stock market upturn is expected this year
- Greater interest in the growth potential of frontier markets
- Due to improved economic conditions, good profit outlook and increased risk appetite, optimism is justified

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**EMERGING MARKETS HAVE FALLEN BEHIND**

For several years, equities in emerging markets have performed much more strongly than in other regions, but last autumn new winds began to blow. Since October 2010, it is instead the US and Japanese stock markets that are on top. Exchanges in Europe have also done nicely in recent months, after lagging behind significantly during 2010. We believe this trend will persist in the short term, although growth potential remains good, especially in the part of the EM sphere known as frontier markets.

Source: Reuters EcoWin
This trend has continued during early 2011. In January, world stock markets rose marginally in local currencies. European markets, the US and Japan performed better than the emerging markets of Asia and Latin America, as they did late in 2010.

**Impressive US company reports**

So far, US company reports for the fourth quarter of 2010 have been better than expected, both in terms of sales and profits. Nearly half of the companies that make up the S&P 500 have published their reports. Their earnings per share rose by 43 per cent compared to the same period of 2009, well above the expected increase of 16 per cent. Companies in the financial sector showed the highest rate of profit increases. Aside from this sector, earnings per share grew by 20 per cent compared to the same period of 2009. Of 236 companies, 193 (82 per cent) announced upside surprises, while 40 (17 per cent) reported worse earnings per share than expected. In a typical quarter, about 60 per cent of companies beat expectations while 20 per cent deliver disappointments.

**Weak start of the year for Sweden**

Early in 2011, Nordic stock market performance has generally been significantly weaker than elsewhere in Europe. Sweden has one of the few stock markets in the entire world without rising share prices. After very strong performance in December, the OMX Stockholm exchange lost more than 1 per cent in January. Early February was also weak, and the exchange has now declined by 1.5 per cent since January 1.

**ROLE REVERSALS**

Last year’s winning equities, which were mainly among cyclical “industrials” and “consumer discretionary” sectors, were weak early in 2011. Instead two defensive sectors, “consumer staples” and “telecom services”, which did not perform so strongly during 2010, have managed the best so far this year. They even showed positive returns when the Swedish stock market was a whole lost ground.

One reason for the weak stock market performance in Sweden is the fourth quarter 2010 company reports which have now begun to appear. In a number of cases, they have not lived up to the high expectations that arose after last year’s sharp price gains, especially among industrial companies. Before the report season, expectations were that companies would report a total sales increase for 2010 of 1.3 per cent and a profit increase, excluding nonrecurring items, of 48 per cent. Market observers also expected dividends totalling SEK 146 billion, which are mainly disbursed in the spring.

A consistent theme during the year-end reporting season has been that companies, especially in the manufacturing sector, have reported sales figures above expectations, while earnings have not grown as fast as during the fourth quarter. This resulted in lower margins than in the third quarter, which the stock market did not appreciate. Looking at major companies that have already published their financial statements for 2010 – at this writing more than 20 – over half did not live up to bottom-line expectations. This is a significantly higher figure than in previous quarters; the figure is often no higher than 25 per cent. As for dividends, however, so far companies have surpassed forecasts.

Swedish listed companies did not quite achieve the desired results mainly because due to the exaggerated expectations of analysts and investors. In recent quarters, analysts have continuously boosted their forecasts, and these have now become difficult for companies to achieve. One factor that had a more adverse impact than expected is that costs of intermediate goods have increased, while the impact of the strong krona was relatively large during the quarter.

**Companies becoming more aggressive**

During 2011 the rate of increase in profits is expected to slow to 17 per cent in the Nordic countries, but sales growth is expected to accelerate to 7 per cent, with manufacturers of intermediate goods leading the way. At least in Nordic listed companies, over the past year the focus of corporate management has shifted dramatically from defensive measures towards capital spending and investment for the future, which is positive. Companies that are more eager to invest, combined with a continued wide gap in the return requirements of the fixed income market and the stock market, are an indication of continued high activity in 2011, including restructuring transactions. The stock market should thus benefit from positive flows of capital from dividends and restructuring transactions, as well as from continued strong profit growth and a normalisation of risk appetite among investors.

In addition, stock market valuations remain quite attractive. During the past three months, the stock market has admittedly risen by more than 5 per cent. But at the same time, profit expectations have been revised upward by more than 4 per cent, which means that valuations have not risen so much. At this writing, the large companies that make up the OMXS30 share index in Stockholm are trading at a price/equity ratio of 12.7. This is not expensive in a historical perspective.
Looking ahead, we will probably see some change in the focus of investor interest, and not only in the form of sector rotation towards more late cyclical companies. Investors will probably also position themselves to a greater extent than before towards companies that find it relatively easier to pass on their costs to customers – often market leaders in their niches – and towards companies that will gain ground because of the strong krona. This means companies that have their costs in euros and/or dollars but their sales primarily in Swedish kronor.

Among threats to the Swedish stock market are higher interest rates and inflation, a strong krona, continued turmoil in the euro zone, high commodity prices and historically high profit expectations in some sectors. But overall, we believe that positive factors will predominate by a wide margin even though storm clouds may create stock market reversals in 2011.

**Bright profit outlook and attractive valuations**

In a global perspective, too, the profit outlook for companies still looks bright. Earnings per share for all companies in the world index are expected to grow by nearly 15 per cent in 2011 and by 13 per cent in 2012. In the US and Japan, profit growth forecasts for 2011 are 13 per cent, while the corresponding figure in Europe is 15 per cent. Profits in emerging markets are expected to rise by 19 per cent in 2011 and 14.5 per cent in 2012. Countries like Malaysia, Mexico, Peru and South Africa will show significantly better growth than average, while China, Brazil and Russia will show profit growth of 15 to 17 per cent. Valuations must be regarded as attractive in a historical perspective.

The world index is currently being traded at a P/E ratio of 13, based on expected 2011 profits and 11 based on 2012 profit forecasts. Equities in emerging market countries as well as in European stock markets look cheaper than in Japan and the US. Comparatively low valuations combined with stable, good profit forecasts will create room for higher share prices.

### Focus on cyclical sectors

Cyclical sectors show better than average expected profit growth in 2011. Commodity and industrial companies along with companies in the financial sector are expected to grow the fastest, unlike such sectors as telecom services and healthcare, which are expected to grow by only 7 per cent. The rate of change in profit expectations is also positive for cyclical companies, while it is a bit more mixed for sectors that are insensitive to economic cycles.

We are now in the midst of a global recovery, with several years of good growth ahead. Because of an improved economic situation, a stable profit outlook, low valuations and increased risk appetite, optimism is justified when it comes to the future performance of the world’s stock markets. We remain positive towards emerging markets, but we are shifting our focus from the giants – China, Brazil and India – to less developed countries with large growth potential, known as frontier markets (for example Indonesia, Malaysia and Thailand). Russia and Eastern Europe are also attractive investment alternatives, with low valuations and high profit growth, which should be part of a global equities portfolio.

### Mature markets may perform well in the short term

In the short term, we also see potential in the mature markets of Europe and the United States. The American economy has revealed upside surprises recently, and US companies are strong after having undergone several years of restructuring. European stock markets lagged behind last year but have started 2011 positively and have more to give, supported by low valuations, as long as we can avoid renewed worries about government finances. By way of summary, we foresee growth expectations and valuations in different regions are not as far apart as previously, but instead have converged toward the world index average.

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**REVENGE OF THE MATURE MARKETS**

Growth expectations for emerging markets as a whole have declined from high levels, while growth in the US and Europe has been helped by the global economic upturn. We thus believe in more synchronised growth between different regions during the next couple of years. Valuations have also converged towards the average for the world index, after previously having moved apart. Equities in emerging markets no longer stand out as extremely cheap.
Unusually multi-facetted fixed income world

- Different cyclical positions lead to different yield patterns
- Government bonds in the OECD are still not appealing...
- ...but High Yield bonds remain attractive

In a world characterised by accelerating economic growth and closely monitored inflation risks, it is natural for both short-term interest rates and long-term yields to rise. This time around, however, trends and conditions are unusually varied in different parts of the world.

While some parts of the OECD industrialised countries are still characterised by very low underlying cost pressure and large gaps between actual and possible production (output gaps), other parts have less idle capacity – with the accompanying somewhat higher risk of inflation – and in places there are significant government financial problems. Another group of OECD countries is showing high growth, mounting risks of overheating and good financial positions.

Another element of the situation is that most of the emerging market (EM) sphere – except for some countries in Eastern Europe – are characterised by a combination of high growth, shortages of available production resources and increased overall inflation, and in some cases also core inflation (excluding food and energy). At least during 2011, the world’s economies can thus be divided into five groups, which will probably show different patterns when it comes to interest rate and yield movements, due to varying degrees of price and cost pressures.

Zero interest rate policies for an extended period
The first group consists mainly of the United States and Japan. The central banks of both countries are pursuing zero interest rate policies, combined with another round of quantitative easing. In addition, these countries have launched further fiscal stimulus programmes. The latter, of course, implies that government financial problems are being postponed. This recently caused one rating agency to downgrade Japanese sovereign borrowing, and the US has received a warning that the same thing may happen there within a couple of years.

We expect the Federal Reserve (Fed) to complete its programme of buying USD 600 billion worth of American sovereign bonds by this summer. The first US key interest rate hike is not likely to occur until the second quarter of 2012. The Bank of Japan will also continue its unconventional monetary policy, and by all indications it will not touch its key rate until about six months after the Fed.

Group two includes the euro zone and the United Kingdom. The output gap in the euro zone is narrower than in the US. Compared to many other central banks, the European Central Bank (ECB) attaches less importance to the fact that core inflation is well below total inflation. In addition, the probable expansion of the European Financial Stability Facility (EFSF) will relieve the ECB of certain tasks related to managing the crisis in the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain).

INITIAL ECB AND BOE RATE HIKES LATER IN 2011

Price risks are a bit larger in the euro zone than in the US, and the economy will strengthen during 2011 in the currency union. This sets the stage for an initial ECB refi rate hike early this autumn. The Bank of England (BoE) must deal with a tricky set of variables, and we predict that it will wait until late 2011 before its first rate hike.
This will allow the ECB to focus on its primary task, price stability, and help pave the way for an initial ECB rate hike early this coming autumn. We expect the BoE, whose decision making scenario includes many variables, to hold off until late 2011 before hiking the British bank rate.

The third group is dominated by mainly commodity-producing countries such as Australia, New Zealand, Canada and Norway, plus Sweden. They are characterised by good economic growth, high capacity utilisation and mounting inflation risks. Their central banks will thus continue on their current paths, raising their key interest rates step by step this year.

Many countries in the EM sphere, especially in Asia but also in Latin America, are quite far along in their upward cyclical curve. This is the fourth group of countries, whose central banks have been hiking interest rates and/or tightening their monetary policies in other ways for the past year or so. Finally, the fifth group of countries consists of Eastern Europe, where Poland recently became the first country whose central bank began its rate hiking cycle. We expect that Russia’s central bank will soon follow suit, but a majority of the countries in the region will be characterised by unchanged or only slightly higher key interest rates during 2011.

As for government bond yields in the OECD countries, we believe that their direction will be upward this year, influenced by good risk appetite in financial markets, a continued – probably stronger – cyclical upswing and a massive supply of bonds to finance large public deficits. These yields are likely to rise only gently in the US, the euro zone, the UK and Japan, partly due to the prospect that the inflation worries will subside. In OECD countries that are characterised by continued rate hikes in the wake of high growth and increased overheating risks, government bond yields will climb a little more.

Rising yields will be accompanied by negative effects on bond prices, and government bonds in the OECD countries are thus not appealing as fixed income investments.

Corporate bonds – especially in the High Yield segment – are still attractive, however. It is true that government bond yields appear likely to rise during 2011 in both the US and Europe, compared to last year’s downturns, which narrowed yield spreads. But these spreads are still large – around 4.75 percentage points in both the US and Europe – and there is reason to believe that they will shrink further this year.

Declining percentage of bankruptcies

The brighter economic outlook is benefiting company sales, profits and balance sheets. This indicates a continued decline in the percentage of High Yield debt-issuing companies that will go bankrupt. Since the end of 2009, the percentage has fallen from more than 13 per cent to about 3 per cent today. It is expected to fall below 2 per cent by the end of 2011. Together with good risk appetite, this will favour demand for High Yield bonds, and to some extent also market interest in Investment Grade bonds. For the latter, however, spreads against government securities are so small nowadays that there is very little room for further narrowing.

During 2010, High Yield bonds in Europe provided a better average return than their American counterparts, despite greater volatility and government financial problems in Europe. But because the economic outlook is now improving more in the US than in Europe, the High Yield market in the US should be able to sail past the European market – especially since the latter is more vulnerable to possible flare-ups of worries connected to the poor finances of the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain).

Bond yields in parts of the EM sphere have recently risen due to key interest rate hikes, high growth and increased inflation worries, subjecting this asset class to considerable headwinds. As a consequence, however, effective yields have become more attractive, both in absolute terms and compared to the OECD countries.

Bond yields in the EM countries may rise somewhat further, but inflation worries are likely to ease gradually if food prices fall after the weather-related increases of recent months and thanks to monetary tightening measures. Together with significantly better finances and current account balances in the EM sphere compared to the OECD, this is one argument for a slowdown in yield increases on EM bonds a bit further ahead.

The prospect of stronger EM currencies in 2011 also make the asset class attractive to investors with, for example, the US dollar or euro as their base currency.
Good opportunities as recovery takes hold

- **Correlation with the stock market is decreasing**
- **More opportunities to generate value, but still quite a lot of beta returns**
- **Quality plays a larger role than in other asset classes**

One fundamental theme of the first Investment Outlook in 2011 is that the world economic recovery is continuing, although the risks should not be underestimated. The recovery is not rapid, but it has enough momentum to generate value. This provides good opportunities for hedge funds, except for "short bias" ones. These are funds that generate value when markets are falling, and in rising markets they will have problems. Of course there are risks that the world economy will not perform according to our main scenario, which would also have an impact on hedge fund opportunities, but these funds have tools that enable them to respond to changed conditions. This is especially true of fund strategies that are flexible and able to use several types of instruments to take their positions. Hedge funds that have a clear "short bias" or "long bias", however, have a tougher time when trends and conditions change.

**2010 – a troublesome year for hedge funds**

At the beginning of 2010, hedge funds had good potential. Because of diminished competition from the trading departments of banks, for example, and the disappearance of some funds, the competitive situation and opportunities of hedge funds looked very good. Unfortunately the economic recovery proved too fragile, leading to several sharp market corrections. This culminated during the second quarter when worries about government finances, especially in the PIIGS countries, created "risk-on/risk-off" trading. This behaviour was difficult for many hedge funds to overcome. Hedge funds as a group lost value – though far less than the stock market – and many funds chose to reduce their risks significantly. As a result, many of them lagged behind when markets improved in the late summer and autumn, when investor confidence in an ongoing economic recovery improved. This meant that 2010 was a year that provided lower returns than normal for many hedge funds. The HFRI, Eureka Hedge and DICS institutional indices maintained good returns, delivering around 10 per cent during 2010, while the broader HDRX index delivered only a bit above a five per cent return.

It was another year driven by market returns (beta), even among hedge funds, and few themes influenced managers. This was one reason why during the second quarter, we chose to unwind most of our Equity Long/Short positioning, since we felt it did not provide a good enough risk diversification effect. We were simply getting too much beta returns, which can be achieved more inexpensively via ordinary equity funds. For private investors with a bit of free time to track their investments, it may still be justified to use high-quality Equity L/S as a base for equity investments, and then spice this with higher risk. Over time, this strategy has the potential to pay off well. Equity L/S strategies with a clear alpha-generating ability both in their long book (shareholdings) and short book (mainly shorting) may possess genuinely good characteristics that we occasionally like to use.

**Important to choose the right manager**

Choosing strategies is important when it comes to which hedge funds we should invest in, but we must not forget the choice of manager. Since hedge funds have such broad investment mandates, the importance of finding the right manager increases. Quality plays a larger role than in other asset classes, where management against a predetermined benchmark often has completely different characteristics. One example of large differences in returns is the 2010 returns on Macro hedge funds, where there were good, bad and in-between outcomes. Some Macro funds are down by double-digit percentages and others are up by double-digit percentages.

Like 2009, 2010 was a year when beta returns played a role. One consequence of this is that the correlation with global stock markets has increased. The following table shows the co-variation between HFRI Equal Weighted Strategies and the MSCI World equity index.
Simulated quality selection, where “worse” hedge funds have been eliminated. Source: Data from HFR and MSCI and calculations performed by Key Asset Management.

The table indicates that hedge funds as a group seem to have shown greater co-variation with global stock markets in the past year. If we limit ourselves to higher-quality hedge funds, we see that their correlation has also risen, although these funds still diversify risk well compared to global stock markets. Properly structured hedge fund portfolios contribute good characteristics to the overall investment portfolio. Those who wish to achieve much lower correlations than shown in the table are fully capable of doing so. It is even possible to achieve a negative correlation if desired.

Moving down to the strategy level, we see that Relative Value has reduced its correlation to stock markets, while other three strategies have increased their correlation. Especially Macro & Trading has changed character. CTA (systematic multi-asset management) in particular shows different characteristics today. During 2010, CTA hedge funds generated value primarily via fixed income investments and central bank interest rates. Since CTA is often used as portfolio protection during troubled times, given its trend-following characteristics (both up and down), we are extra attentive to changes in character that might have negative effects on portfolios. We expect that the situation will normalise and that CTA can continue to be used in about the same way as previously.

Equity L/S has also greatly increased its co-variation with stock markets, and we have seen some of the same effect in Event Driven & Distressed strategies.

<table>
<thead>
<tr>
<th>Qualitative selection – correlation between strategies and MSCI World (price index)</th>
<th>1 yr</th>
<th>3 yrs</th>
<th>5 yrs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity L/S</td>
<td>0.46</td>
<td>0.29</td>
<td>0.30</td>
</tr>
<tr>
<td>Event Driven &amp; Distressed</td>
<td>0.53</td>
<td>0.44</td>
<td>0.44</td>
</tr>
<tr>
<td>Relative value</td>
<td>-0.16</td>
<td>-0.07</td>
<td>-0.05</td>
</tr>
<tr>
<td>Macro &amp; Trading</td>
<td>0.26</td>
<td>-0.19</td>
<td>-0.07</td>
</tr>
</tbody>
</table>

Source: Data from HFR and MSCI and calculations performed by Key Asset Management.

The normalisation of financial markets as the economy slowly improves will mean more opportunities to generate value for hedge funds. Last year’s risk-on/risk-off trading will be replaced by multiple opportunities, which we expect to reduce the correlations and move characteristics back to more normal levels. Thanks to these factors, 2011 should be a good year for a large proportion of hedge funds than in 2010, when only more high-quality/institutional hedge funds delivered good results.

Most hedge funds have now achieved their high water mark. In other words, invested capital has been restored to the level where the funds can begin earning performance fees. This should mean that the funds can now begin to be even more constructive in their investments, which might boost their returns somewhat compared to the caution typical of their managers when they are below the performance fee level.

Taken together, these opportunities and characteristics make us quite hopeful that 2011 will be a good hedge fund year and that we will achieve the effects we want in our portfolios from this asset class. Conditions look especially promising for Global Macro, CTA, Event Driven and Relative Value strategies, while we should be more cautious about Short Bias, volatility strategies and long equity hedge funds.

PERFORMANCE OF VARIOUS HEDGE FUND INDICES, 2006-2010

Hedge funds have bounced back from their downturn during the crisis, but there are big differences between “institutional” and “broader” indices. The HFRI, Eureka Hedge and DIICS institutional indices maintained their returns well, delivering around ten per cent during 2010.
The foundation is laid – time to build phase two

- The US is looking better but recovery is slow
- China seems to have its real estate market more or less under control
- Low new construction volume in the West is supporting the real estate market

In previous issues of Investment Outlook, we have commented on the recovery of the real estate market after the global financial crisis. We have argued that the recovery would occur in different phases. Last year we were in the first phase, which was investor-led. Investors with available capital took advantage of the situation that arose during the crisis to buy what are considered high-quality properties in first-class cities such as London, Paris, New York and Washington, D.C. There was great interest in these markets, and good properties were priced accordingly. Here the rate of return on properties is now at the level of 2007, when it was at its lowest and the price was thus highest.

In order for phase two to begin, the global economic situation must continue to improve and lead to higher consumption. This will result in increased demand for office space, industrial premises, hotels and flats. The status of the market is visible in transaction volumes, and 2010 was a year when these improved greatly. The global rate of increase compared to 2009 was more than 40 per cent for decent-sized commercial properties.

Encouragingly, the US is finally beginning to deliver positive figures. It seems as if the recovery in the commercial real estate market is beginning to happen, though the recovery remains sluggish for private homes. We also saw in the latest ISM purchasing managers’ index in the service sector from January 2011 that the US economy is starting to move. The index came in at 59.4 compared to 57.1 in December. That was its highest level since August 2005. Transaction volume in the US improved by 133 per cent compared to 2009, according to Real Capital Analytics (RCA). This was a large upturn, but lagged behind both Europe and Asia, which had rebounded earlier. Despite last year’s upturn, the level of transactions still only reached 24 per cent of the 2007 peak, so there is some way left to go. Europe is at 40 per cent of its previous peak transaction level, and Asia is 10 per cent above it.

GROWING INTEREST IN COMMERCIAL PROPERTIES

Transaction volume is increasing, but the US and Europe are a long way from their previous peaks. (EMEA = Europe, Middle East and Africa)
Source: RCA.
For American private homes, the picture is a little worse. The most recent S&P/Case-Shiller index, based on data until the end of November, declined. It even fell below the level of one year earlier. The recovery will take time, but some improvement will certainly come when the spring and summer season begins. Solid demand will not resume until 2012. There are still numerous properties in foreclosure or short sale, and they will take a long time to sell. There are of course exceptions, with some cities or regions beginning to move earlier than the overall market, but on the whole the housing market remains sluggish.

**NO IMPROVEMENT YET FOR US HOME PRICES OR HOME BUILDERS**

![Graph](image)

The recovery in American home prices was interrupted in November, and it will take time for the market to bounce back. Many homes are in foreclosure or short sale and will take time to sell. The National Association of Home Builders (NAHB) index still shows a shortage of jobs for builders.

But the year ended on a positive note for private homes when sales of new US single-family homes rose by a surprising 17.5 per cent month-on-month in December – well above the expected 3.5 per cent. This still represented a 7.6 per cent downturn year-on-year, but the big increase was still a satisfying indicator.

Although there are many positive developments in the commercial portion of the US real estate market, there are also negative factors that underscore the differences between segments. A report from Trepp on February 2 this year shows that loan payments more than 30 days past due are increasing. Meanwhile there are indications that the total volume of problem loans is falling for the first time in several years. This shows that there are still major variations in financial strength among different US property owners. Some aspects of the real estate market are beginning to work quite well, while those associated with housing are having a tough time. The market is recuperating, but more time will be needed before it is completely healthy.

Most of 2010 was a year of prime locations, with cities like London and New York doing significantly better than other areas. However, the fourth quarter demonstrated that the time for other areas was beginning. Secondary areas of Europe such as Manchester, Rotterdam and Gothenburg also began to show strong growth, with increases of more than 100 per cent in transaction volume compared to the preceding year. This put them among the 25 top cities in Europe. Notably, 11 of these 25 cities are in Germany and the Nordic countries, which have all been early in the economic recovery cycle. Indications from the real estate sector in Stockholm are that 2011 will be another good year, with high transaction volume.

In China, there have been fears that a real estate market bubble was building up – 80 per cent of the world’s new construction in 2010 occurred in China – but the authorities were quite successful in keeping the market under control for most of the year. Their actions clearly pushed down transaction volume, but during the fourth quarter activity took off again to the second highest level in four years. The situation will apparently require further action again, but given the resources available to Chinese authorities, the odds are on their side, especially since we are now seeing some slowdown in overall economic activity.

**Little new construction in the OECD countries**

The lack of new construction in the industrialised countries will reduce vacancies in existing properties as demand rises. Rent levels have stabilised in many cases, and in many cases they are also rising. Return requirements on investments have also stabilised or are on their way down, implying better real estate markets and higher prices. But as long as demand is not enough to fill existing properties, new construction will not take off and construction companies will thus continue to have difficulties.

For investors who have been able to buy properties after the crisis, the picture looks bright. Real estate investment trusts (REITs) cleaned up their balance sheets at an early stage and raised new capital from their owners during 2009 and 2010. Because of the large price upturn for REITs during 2010, most of the expected upturn has already occurred, but these trusts are still on a stable foundation for the future. However, 2011 should be a year of consolidation for REITs as they take care of their properties and work towards streamlining management of them.

To summarise, the global recovery is under way, and this is having a positive impact on real estate markets. The situation is still quite far from being healthy, but the market is recuperating at a decent pace. There are fears here and there, but on the whole the picture is becoming brighter and financial investors would do well to have some of their capital invested in real estate.
Growth will boost valuations

- Normalisation of markets will create good potential
- Lingering risks are reflected in low valuations
- Prospects of better returns than the historical average

This winter the private equity (PE) market has continued to normalise. The pace of transactions has increased, the financing market is operating again and “business as usual” prevails. But naturally not everything is as usual. In the wake of the credit crisis and deep recession, a number of question marks are waiting to be addressed. However, we believe that relatively low valuations reflect the risks that exist. Meanwhile we are in the phase of the economic cycle when PE companies normally perform at their best. We do not believe that this time is an exception. We expect a more normal state of affairs in the PE market, but with prospects of better returns than the historical average.

In the last Investment Outlook we predicted that more stable growth would drive values of PE companies and that there would be good business opportunities for strong players in the sector, but that financial worries risk making the journey a bumpy one. Developments since then have largely followed this scenario, and this basic picture essentially remains in place.

Back to normal
Several important, fundamental conditions for PE companies, which were turned upside down during the recession and credit crisis, are now back to their normal state. This applies especially to:
- general economic conditions
- the financing situation
- the potential for transactions
- the price picture

It is well known that the economy is in a more normal growth phase. Amid all the alarming news about debt problems and imbalances, it is important to remember that according to our (and most other observers’) forecasts, the world economy will grow very nicely during the next couple of years. It is also important to note that even though emerging countries account for the greatest strength, forecasts are now indicating decent growth in Western countries as well, especially the United States. More widespread global growth is likely to benefit many PE companies.

In most cases, the PE sector uses leveraging to acquire companies. Potential buyers of companies often also need financing, so the credit situation is important to the PE sector. Having practically been in the deep freeze a little over one year ago, the credit situation is now nearly normal. Stable PE companies can again finance their transactions via the bond market. Bank lending is also under way again, although banks now require that borrowers supply a higher percentage of equity than before the crisis. This helps ensure greater stability, but it reduces leveraging of investments and thus demands greater operational skills by the PE sector in developing portfolio companies.

As for potential transactions and the price picture, numerous corporate transactions are now occurring. A large percentage of these transactions are still between different financial players (PE companies), but more and more initial public offerings (IPOs) are being launched, and “industrial buyers” (companies in the same industry) have also begun to be active on the acquisition side. Given the economic outlook and generally strong company finances, this trend will continue. As for the price situation, portfolio companies are now trading at about their 2005-2006 values, which are more normal than the peak levels of 2007 or the bottom levels of 2009.

Higher discount to NAV than the historical average
The prices of PE companies themselves are among the things that are not yet back to normal, however. Discounts to net asset value (NAV) for listed PE companies have levelled off during the past year but remain higher than the historical average. These discounts are around 25-30 per cent, compared
to a historical level of 10-15 per cent. We consider it justified for these companies to trade at a large discount for another while, considering the elements of uncertainty still remaining after the crisis.

The most important elements of uncertainty are:
- worries about take-overs
- question marks about future levels of return
- strong interest in selling among investors

Take-overs as a phenomenon occurred during the peak years when low interest rates, nearly unlimited access to financing and strong historical growth persuaded many investors to make large PE commitments that they could not always live up to. This has largely been remedied in most places, but there are still some question marks. It is also justified to think about where return levels will end up in the future. Given that a larger equity stake is now required, of course the percentage return on this will diminish, all else being equal. Many large investors also put money into PE companies around the peak a few years ago, among other things for reasons of risk diversification. Having been severely burned during the market free fall, many institutional investors have now decided to withdraw from the PE sector. There may be a large supply of shares for sale for some time to come.

In our opinion, these sources of uncertainty justify today’s discounts. It is worth noting, however, that discounts on existing PE commitments, or secondaries, are back at their average historical levels.

As usual – but better
To summarise, we thus believe that the fundamental conditions for PE are back to their normal state and that lingering uncertainties are reflected in large discounts. At the same time, we maintain that returns have the potential to be higher than the historical average. The main reason for this is that we are in the phase of the economic cycle when (successful) PE companies experience their most successful years. With several years of good economic conditions ahead and with a recession behind them, PE companies have good opportunities to improve the value of the companies that they own, while carrying out transactions at reasonable prices. Many listed companies are reporting very good profit growth – a trend that looks as if it can spread to additional sectors as the economic upturn broadens. The situation is likely to be generally similar for the companies in the PE companies’ portfolios. Many PE companies also still have high loan-to-value ratios, which increases their return on equity. Taken together, this means that book values or net asset values (NAVs) should be able to grow nicely over the next couple of years. During the second half of 2010, they appear to have risen by nearly 10 per cent.

In addition, a general stabilisation should create the potential for some reductions in today’s discounts to NAV. There are also reasons to believe that today’s NAVs are being set on the basis of rather conservative principles, and there is thus room for some increase in valuations for that reason.

Given the remaining uncertainties, and with many players on both the buyer and seller sides, there is an obvious risk that the journey will be a rough one in terms of the share prices of PE companies. Optimism nevertheless has the upper hand. Because of good economic growth and good company profit increases, combined with the fact that the risks are reflected in valuations and that the cyclical phase is favourable, we expect good return figures ahead as well. The rapid recovery from crash levels is behind us, but we consider it reasonable to expect returns in the upper part of the normal range. If our forecast of a good future stock market climate proves correct, the PE sector should be able to deliver clearly better returns than the stock market during the next few years.

Since the stock market bottomed out nearly two years ago, shares of listed PE companies have risen almost twice as much as the world stock market index. But share prices of PE companies fell substantially more in the preceding downturn. Although it is possible to argue that their peak pricing was a bubble, there should still be potential for significant upturns.
Economic upswing lifting commodity prices

- Aluminium the most attractive industrial metal
- Oil service an appealing sector
- Gold prices may continue to fall

As the global recovery has unfolded, commodity prices have generally continued to rise. Now that the economies are also spinning faster in parts of the OECD such as the US, Germany and the Nordic region, demand will no longer be coming exclusively from the emerging market (EM) sphere. Aside from higher demand pressure, weather related disruptions and a weak US dollar have helped increase commodity prices.

Despite already sharp increases, with some commodity prices at record levels, we predict that price pressures will continue during 2011. The main reason is that the global recovery will broaden and world economic growth will continue to rise rapidly during both 2011 and 2012 (at about 4.5 per cent annually). Compared to last year, growth will slow somewhat. The upturn in commodity prices should also be gentler than in late 2010. For commodity prices, however, the level of GDP growth is usually more important than the change.

The worries that surround the world economy are the same as last year, but they appear somewhat less threatening today. Debt crisis management in southern Europe has earned renewed confidence, and the American economy has shown surprising strength. The biggest question market concerns the Chinese economy and how it will be affected by the economic policy tightening measures that the authorities are imposing in order to ease higher inflation pressures.

On the whole, the global economic climate will sustain continued rising commodity prices. But as in the stock market, we are likely to enter a phase where it will be increasingly important to distinguish between different investments. In recent years, commodity prices have risen on a broad front. Today, however, there are likely to be larger discrepancies in returns, so it will be important to identify the potential of each individual commodity.

Broad demand for industrial metals

Industrial metals have the closest correlation with economic growth. During two years of global recovery there has been heavy demand for industrial metals, as reflected in sharply rising prices. While we believe that the prices of industrial metals should be higher at the end of 2011, we are not likely to see the same rapid price increases as previously. A sharp deceleration in Chinese growth is the foremost threat. Although the economic wheels are now turning faster in the OECD countries, the EM sphere still accounts for more than 50 per cent of global growth and China is by far the biggest contributor.

We are continuing to single out copper and aluminium as the industrial metals that have the greatest potential. Since we launched copper and aluminium as a trading suggestion in the publication *Opportunities* (October 19), the price of copper has risen by a full 19 per cent, while the price of aluminium has increased by a much more modest 7 per cent. Because aluminium price increases have lagged behind, aluminium currently looks like the more attractive alternative of the two.

The global recovery is increasing the demand for commodities. Price pressure should continue during 2011, but price increases are likely to be gentler than during late 2010.
Oil service sector attractive
Crude oil is now trading at about USD 100 per barrel. Cold weather in the northern hemisphere – combined with greater optimism about the global recovery – has been the main factor pushing up prices. The political crisis that flared up recently in North Africa has also contributed. Short-term driving forces should diminish in strength, and we may thus see a correction down to USD 90 per barrel, but strong global growth is likely to keep oil prices at high levels.

For some months, we have highlighted oil service as an attractive sector, and the outlook remains bright for this industry. Oil prices at today's levels justify higher investment budgets for oil producers, which will benefit the oil service companies.

La Niña controlling agricultural commodities
The El Niño weather phenomenon has been succeeded more recently by La Niña, but the effect on agricultural commodities is the same. Since mid-2010 extensive weather-related disruptions, mainly in Australia and South America, have driven agri-commodity prices to new heights. The risk premium is likely to persist during the coming quarter, but the effects of La Niña should fade during the second half of 2011 and we may then see falling prices. Looking further ahead, however, a growing middle class in the EM sphere will probably mean higher agri-commodity prices.

Shaky gold prices
When the last issue of Investment Outlook was published, the price of gold had passed USD 1,400 per ounce, and we argued that there was a major risk that the "gold bubble" would burst. Fluctuating risk appetite and an escalating currency war increased demand for gold last year and helped push up its price by a full 30 per cent. Given our view of the market, including stronger global growth, increasing risk appetite and somewhat higher interest rates, it was difficult to justify this high price level. In addition, there is always a "best before" date on all market themes. Our assessment was that the market's focus on a global currency war would fade and that interest in gold would thus also cool.

The upward trend for gold ended around the turn of the year, and this year gold prices have fallen by 4 per cent. We predict that gold may continue to lose value. Arguments pointing towards a continued price decline are the combination of a world economy in steadily improving health and an excessive increase in gold prices in a short period, but there are also factors that support the opposite argument. Inflation has recently taken off in a number of EM countries, and during periods when there is a focus on inflation worries, the demand for gold is usually heavy. In large parts of the Western world, however, inflation pressure is mild. In addition, the financial situation in southern Europe is still fragile, and if the market once again turns hesitant about the survival of the euro system, gold is likely to become a refuge for investors. But as the EU and IMF’s European Financial Stability Facility has been granted increased crisis management authority, concerns about the European debt crisis have eased.

In our assessment, oil prices will remain high during 2011, which should benefit the oil service sector. Oil prices at today’s levels justify higher investment budgets for oil companies, thus benefiting oil service companies.

After strong increases in 2010, the price of gold has fallen slightly this year (4 per cent). Strong global economic growth, high risk appetite and low inflation pressure could lead to a continued price decline.
Interest rate spreads are back to stay

- Currencies and countries on a rate hiking path will benefit
- 2011 will be another strong year for the Swedish krona
- China will step up yuan appreciation

In recent issues of Investment Outlook, we have stated that the fundamental strengths of countries and currencies, as well as interest rate differentials (spreads), will control developments in the foreign exchange market. This assessment has largely proved correct. Countries with sound finances and strong economic growth have seen their currencies strengthen. Recently, investors who take advantage of interest rate spreads have also increasingly influenced events in the FX market. At present we see no reason for these trends to cease.

Carry trade takes the stage
Investors take advantage of interest rate spreads by borrowing where interest rates are low and investing where they are high. This trading pattern is called the “carry trade”. The result is downward pressure on those of countries with low interest rates, while the currencies of countries with high interest rates become stronger. During periods when the carry trade has been a market theme, investors have thus earned returns both on currency appreciation and higher interest rates.

Taking advantage of interest rate spreads became popular late in 2003 and remained an influential theme until the financial crisis of 2008. When the crisis broke out, investors chose to close their carry trade positions, which meant that they sold high-interest currencies and bought low-interest currencies. At that time it became painfully clear how quickly sharp currency rate movements can wipe out the returns on positive interest rate spreads. The carry trade is thus based on low volatility in the FX market, often synonymous with high risk appetite.

Most of the factors that were in place during the recovery after the dotcom (IT) crash of the early 21st century are also visible today. Now, as then, the world economy is beginning to re-

awaken, interest rates are low, risk appetite is high as reflected in rising share prices, and volatility in the FX market is gradually falling. These ingredients indicate that the carry trade will again play a major role on the currency stage.

The yen as a financing currency
Historically, the Japanese yen (JPY) has assumed the role of financing currency in carry trade transactions, and there are many indications that history is repeating itself. The yen has appreciated significantly in recent years. According to SEB’s valuation model, the JPY is more than 30 per cent overvalued against the USD. There is thus not so much room for continued appreciation, which is preferable in a financing currency. Furthermore, the gap between key interest rates in Japan and other countries is likely to continue widening, since it will take some time before the Bank of Japan abandons its zero interest rate policy. The Swiss franc (CHF) also has characteristics that make it attractive as a financing currency.

If we are correct in assuming that the carry trade will again become a theme in the foreign exchange market, the JPY and CHF should thus weaken. Currencies in countries where the

FUNDAMENTALS AND INTEREST RATES SET TONE

Fundamental factors such as GDP growth and financial stability have set the tone in the foreign exchange market. The chart shows how the fundamentally strong AUD, CAD, NOK and SEK have changed in value against the fundamentally weak EUR, USD, JPY and GBP. There is an increasing focus on interest rate spreads, and countries with strong economies are the ones hiking their key interest rates.
central banks are in the process of raising key interest rates should appreciate. Among these are the SEK, NOK, CAD, AUD and most emerging market (EM) currencies. Aside from rising key interest rates, these currencies and countries are characterised by strong growth, solid government finances and low public debts.

**Tailwind for the krona**

When risk appetite is low, large and liquid currencies benefit while small and illiquid currencies lose ground. This is why the Swedish krona bottomed out when the financial crisis was raging at its worst (SEK 11.60 per euro). Since then, the krona has made a remarkable recovery and is now at its strongest level against the euro since 2001 (SEK 8.80). There are many indications that this trend will continue in 2011.

Further interest rate hikes by the Riksbank and Sweden’s good finances are two major reasons why the SEK will remain strong, but there are also other reasons in favour of the Swedish currency. The krona is cyclically sensitive and is influenced by trends in global demand. When the world economy improves and the demand for Swedish export goods rises, the demand for kronor also increases and vice versa. In our judgement, 2011 will be a good year for the world economy, with growth of about 4.5 per cent compared to the historical average of around 3.5 per cent.

One thing that weighed down the krona exchange rate during 2008/09 was the exposure of Swedish banks to the crisis-plagued Baltic countries. The situation in that region has improved significantly, however, and the focus of the market is instead on debt-burdened southern Europe. The krona has thus become something of a safe harbour for investors who are sceptical about the future of the euro. Our assessment is that by year-end, the krona will have strengthened to about SEK 6.00 per dollar and to SEK 8.50 per euro.

**The least bad alternative**

The most heavily traded currency pair in the market is the EUR/USD, and the choice between the world’s two largest currencies has long been a matter of finding the least bad alternative. The EUR/USD exchange rate has moved within the 1.20-1.40 interval for a long time, depending on where the situation looked gloomier at the moment. Since the beginning of 2011 the euro has regained strength, and we believe this trend will continue in the near future. The reason is that the ECB will begin its rate hiking cycle about six months ahead of the Fed. The euro will also gain support as the market begins to look closely at the measures being planned in order to manage the European debt crisis. This mainly centres on the EU’s and IMF’s European Financial Stability Facility and proposals to give the EFSF increased crisis management powers.

Our forecast is that the EUR/USD exchange rate will continue to climb, reaching 1.45 during the third quarter. Next year the dollar will regain lost ground, due to the continued American economic recovery and the fact that the Fed will begin hiking its key interest rate. By the end of 2012, we estimate that the EUR/USD rate will stand at 1.30, which is still a bit above its long-term equilibrium rate of around 1.20.

**China will step up pace of yuan appreciation**

One prerequisite for a full rebalancing of the world economy is that China should abandon its "managed float", in which the yuan is allowed extremely little room to fluctuate against the dollar. Since June 2010, Chinese authorities have allowed some yuan appreciation (about 3.5 per cent against the dollar). Continued appreciation is in the interest of China and other countries, and we believe that the pace of appreciation will accelerate.

Our forecast is that the USD/CNY exchange rate will stand at 6.45 at the end of the second quarter of 2011.

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**The krona will remain strong**

The Swedish krona has regained lost ground since bottoming out in March 2009, and there are many indications that this strength will continue for another while. The chart shows the KIX index, which is the krona in relation to a trade-weighted currency basket.

**Gradually stronger yuan**

Since last summer, Chinese authorities have allowed a gradual appreciation of the yuan (renminbi), which has strengthened by 3.5 per cent to date. Continued appreciation is in the interest of China and other countries, and we believe that the pace of appreciation will accelerate.
PERFORMANCE OF DIFFERENT ASSET CLASSES SINCE 2000

- Return in 2011 is until January 31, 2011.
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SEB Private Banking has a broad client base that includes corporate executives, business owners and private individuals of varying means, each with different levels of interest in economic issues. To SEB, private banking is all about offering a broad range of high-quality services in the financial field – tailored to the unique personal needs of each client and backed by the Group's collective knowledge.

SEB Private Banking has some 350 employees working in Sweden, Denmark, Finland and Norway. Outside of Sweden, we take care of our clients via offices in Estonia, Geneva, Latvia, Lithuania, Luxembourg and Singapore as well as a branch in London. On December 31, 2010, our managed assets totalled SEK 264 billion.