Investment Outlook

February 2012

Surprises may be waiting around the corner

PRIVATE BANKING - INVESTMENT STRATEGY

SEB

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This report was published on February 21, 2012.
Its contents are based on information available before February 14, 2012.

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Times they are a changing...

Times change, and so do perceptions of what is a good and a bad risk in the capital market. Right now a certain calm has descended over financial markets. But behind today's forecasts, new tensions and issues are building up globally, which will increasingly affect our investor world.

Since 2012 began, we have seen a whole new trend in global capital markets. Willingness to invest has greatly increased, and we may have seen a genuine turning point in risk appetite since November 2011. The final forward nudge came after the European Central Bank (ECB) took action. Put simply, markets need three things in order to move: liquidity, an economic trend and reasonable valuations. In recent months, all three have been on the "right" side.

Worth reflecting about is that during this period no major, far-reaching decisions have been made in order to resolve the long-term problems of the euro zone. It is, above all, the effects of the ECB's offer to supply banks with unlimited liquidity that have done the job of stimulating risk appetite.

Meanwhile we note that GDP forecasts for 2012 are increasingly grouped around a growth rate just above the level where we may expect some growth in profits. The second half of the year is expected to be better than the first, and we have reason for a degree of hope further ahead. Sometimes when the consensus is relatively uniform, the unexpected can happen. In light of the above, in this issue of *Investment Outlook* we have explored various alternative scenarios in depth, in case the unexpected happens.

The euro zone crisis is under way at this writing, and in various ways it will probably be a part of our reality for a long time to come, which justifies another theme article in this issue.

Right now a certain calm has descended over capital markets. The consensus view of global growth is fairly homogeneous, and forecasts indicate some growth. European banks have ample liquidity, and the market's risk appetite has increased. But behind today's forecasts, new tensions and issues are building up globally. These will increasingly affect our investor world.

Today we have youth unemployment that, in many countries, is extremely high. These are the same young people who are supposed to finance the pensions of a growing number of older people. In addition, in more and more countries, fewer and fewer children – who are expected to financially sustain an ageing population – are being born. This will raise questions about saving, debt and how work and consumption will evolve. The tax base will constantly change in order to finance public sector consumption. We will be forced to make some tough decisions.

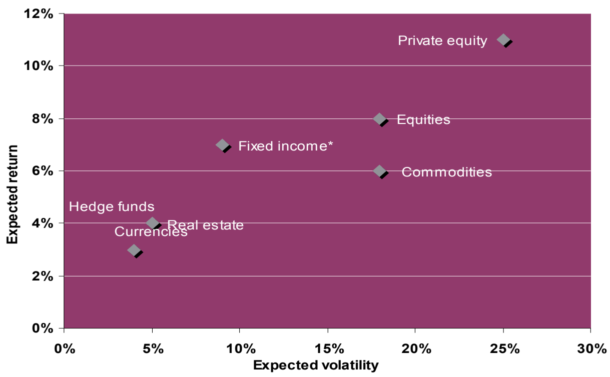
In this future scenario, questions will be raised about capital supply, how savings will be built up and allocated, and how living standards will be maintained. These will be interesting times, when production systems must generate value in a different way. More people – especially the young – must go to work. The relative competitiveness of different regions will change. We will see many opportunities in the next few years. And some of them will be unexpected.

HANS PETERSON
CIO Private Banking
and Global Head of Investment Strategy

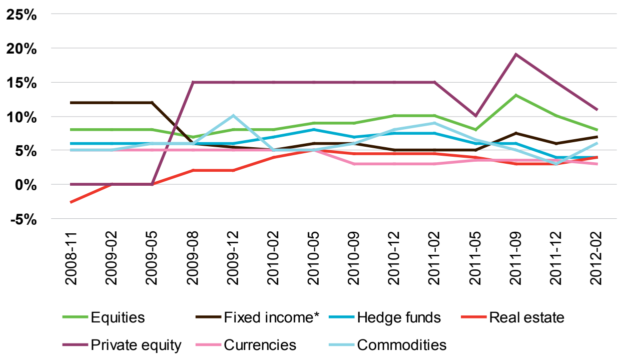
	Expectations* Next 12 months return	risk	Reasoning *Forecasts are taken from the SEB House View and are based on our economic growth scenario (see page 8).
Equities [1]	8%	18%	**NEUTRAL** outlook in the short term, **POSITIVE** in the long term. Low valuations in many countries, except the US, which has continued to deliver positive surprises. Limited upside, since volatility is already low. More stable balance sheets in various sectors, including banking. Many emerging markets fell sharply in 2011 and are now considered relatively cheap. High, stable returns but affected by growth in the OECD countries.
Fixed income [2]	7%	9%	While OECD governments have weakened financially in recent years, companies have instead become stronger. This is the fundamental reason why we are **POSITIVE** towards corporate bonds and **NEGATIVE** towards government bonds. Government bond yields are expected to rise slightly this year. Meanwhile yield gaps between corporate and government bonds may shrink considerably/corporate bond prices may rise, as the market realises that current pricing, especially of high yield bonds, reflects an excessively pessimistic economic scenario. Risk appetite will also benefit emerging market (EM) debt.
Hedge funds	4%	5%	**POSITIVE.** The market climate is especially favourable towards CTAs and credit-oriented hedge funds. Our focus is on non-equity-related management and funds that replace government bonds from a portfolio standpoint.
Real estate	4%	5%	**NEUTRAL.** Transparency is still low. Credit problems pose a risk, but the market is resilient. Strong demand for properties in primary markets has squeezed yield requirements, but interesting cases of good returns can be found.
Private equity	11%	25%	**NEUTRAL.** Good growth and low valuations (large discounts) mean sizeable potential in the longer term, given an improved market climate, but financial uncertainty will generate worries in the short term.
Commodities [3]	6%	18%	**NEUTRAL/POSITIVE.** Increased risk appetite has lifted most commodity prices in recent months. A soft landing in China is the key to continued upturns for industrial metals. Normalised weather conditions will lead to falling prices for agricultural products. Oil price levels will remain high.
Currencies [4]	3%	4%	**NEUTRAL.** Given a continued increase in risk appetite, EM currencies should benefit from interest rate differentials and growth. China is likely to continue revaluing the yuan (renminbi) against the USD, though at a slower pace. The USD will be stronger than the EUR, with its overhanging southern European debt crisis. The yen is regarded as overvalued.

[1] The forecast refers to the global stock market. [2] The forecast refers to a basket of ½ investment grade and ½ high yield.
[3] The forecast refers to a basket in which the energy, industrial metal, precious metal and agricultural commodities categories are equally weighted.
[4] The forecast refers to the alpha-generating capacity of a foreign exchange trading manager.

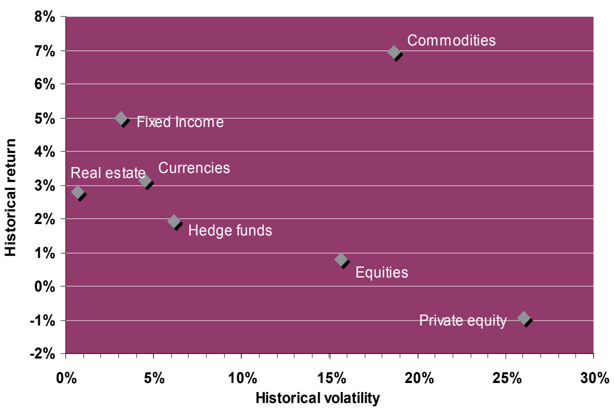
EXPECTED RISK AND RETURN (NEXT 12 MONTHS)



CHANGE IN OUR EXPECTED RETURN



HISTORICAL RISK AND RETURN (FEBRUARY 28, 2002 TO JANUARY 31, 2012)

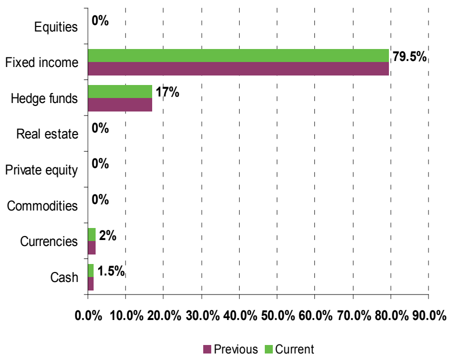


HISTORICAL CORRELATION (FEBRUARY 28, 2002 TO JANUARY 31, 2012)

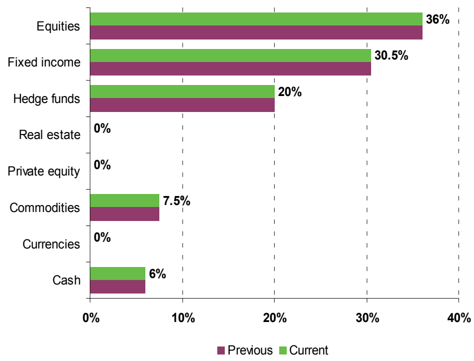
	Equities	Fixed income	Hedge funds	Real estate	Private Equity	Commodities	Currencies
Equities	1.00						
Fixed income	-0.47	1.00					
Hedge funds	0.58	-0.31	1.00				
Real estate	-0.13	0.09	-0.04	1.00			
Private equity	0.85	-0.37	0.67	-0.14	1.00		
Commodities	0.24	-0.18	0.68	-0.04	0.38	1.00	
Currencies	-0.18	0.20	0.13	-0.12	-0.06	0.03	1.00

Historical values are based on the following indices: Equities = MSCI AC World EUR. Fixed income = JP Morgan Global GBI EUR Hedge. Hedge funds = HFRX Global Hedge Fund USD. Real estate = SEB PB Real Estate EUR. Private equity = LPX50 EUR. Commodities = DJ UBS Commodities TR EUR. Currencies = BarclayHedge Currency Trader USD.

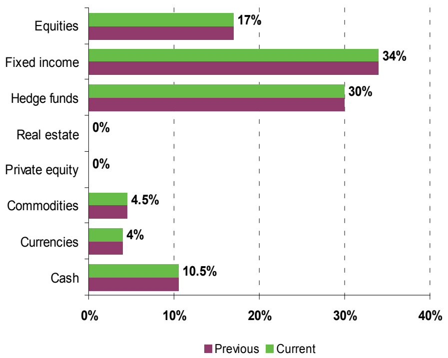
WEIGHTS IN MODERN PROTECTION



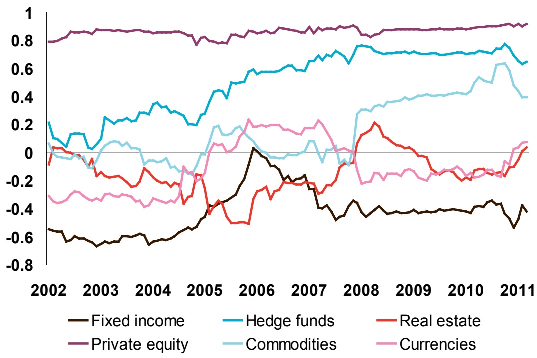
WEIGHTS IN MODERN AGGRESSIVE



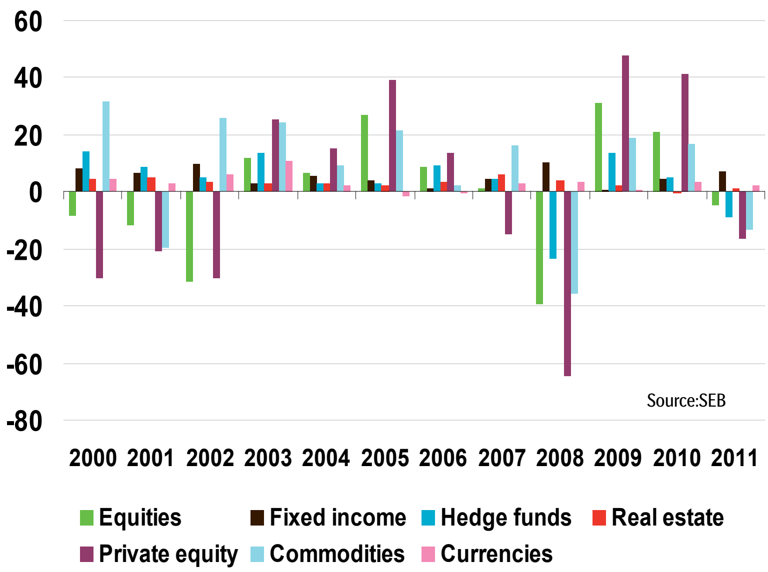
WEIGHTS IN MODERN GROWTH



ROLLING 36-MONTH CORRELATIONS VS. MSCI WORLD (EUR)



PERFORMANCE OF DIFFERENT ASSET CLASSES SINCE 2000



Return in 2011 is until December 31.
Historical values are based on the following indices: Equities = MSCI AC World EUR. Fixed income = JP Morgan Global GBI EUR Hedge. Hedge funds = HFRX Global Hedge Fund USD. Real estate = SEB PB Real Estate EUR. Private equity = LPX50 EUR. Commodities = DJ UBS Commodities TR EUR. Currencies = BarclayHedge Currency Trader USD.

Stabilisation – and some hope for growth

- *Global economic risks have decreased…*
- *…and the US economy in particular has delivered upside surprises*
- *But many worries remain, so it is not yet time to stop being vigilant*

The world economic situation has stabilised this winter. Central bank actions have reduced the stress in the financial system. The euro zone countries have taken hesitant steps towards greater coordination and deeper integration. In addition, unexpectedly strong economic signals have been especially prominent in the United States, easing worries about a global recession. There are still major risks, however, for example in the form of a deep recession in southern Europe, diminished yet still relatively high stress in parts of the financial system and fundamental global imbalances related to competitiveness and trade flows.

Having previously had a clearly negative bias, our risk scenario for growth in the OECD countries now seems more balanced. As earlier, a deeper euro zone crisis is the biggest threat, while the best positive potential is found in the US economy. Inflation will fade in many parts of the world during 2012, thanks to lower commodity prices and low labour cost increases. In the emerging market (EM) sphere, lower inflation will open the way for key interest rate cuts. It also promises a soft economic landing and growth that will hold up relatively well.

No US recession despite European contagion

The US will avoid a recession by a wide margin, although the country is affected by European problems via trade, tighter financial conditions and lower bank lending. Yet the European debt crisis will create obstacles to a normal US recovery, and continued debt deleveraging in the US household sector will also restrain growth. Federal fiscal policy looks likely to be less contractive than expected this year, but the headwinds will be stronger next year. We expect GDP to increase by 2.5 per cent in both 2012 and 2013. Unemployment will remain above 7.5 per cent until late 2013. Core inflation is expected to fall below 1.5 per cent later this year. This may open the way for a further Federal Reserve bond purchasing programme after the summer, probably focusing on mortgage-backed securities.

Not all gloom and doom in the euro zone

The euro zone countries face painful choices ahead. Additional fiscal tightening in crisis-hit countries that is not offset by expansionary measures from Germany and the European Central Bank (ECB) will risk deepening the crisis and escalating political tensions, but there have recently been various signs of stabilisation. Some macroeconomic statistics have provided upside surprises, and there have been bright spots in economic policy. The ECB's three year loans are easing pressure on the banking sector. Germany and France have indicated openness to slower implementation of the Basel III rules, further easing financial stress. There are also stricter budget controls as well as reform-minded governments in both Italy and Spain. The risks of a deep euro zone recession have thus decreased somewhat. We expect euro zone GDP to shrink by less than 1 per cent this year and then grow by more than 0.5 per cent in 2013.

Olympics will be important to British growth

Since the euro zone is the United Kingdom's most important trading partner, buying 30 per cent of exports, foreign trade cannot lift the British economy. Yet there are bright spots in industry as well as in construction and services. Taken together, indicators are compatible with a stagnating economy, but this summer's London Olympic Games will provide growth in various sectors. We foresee GDP growth of less than 0.5 per cent this year and nearly 1.5 per cent in 2013. Inflation will fall steeply to well below the Bank of England's 2 per cent target in 2013. Further central bank bond purchases are thus likely.

Nordic countries feeling brisk southerly debt winds

Via slowing exports, flagging optimism and negative wealth effects, the Nordic economies have been greatly affected by euro zone problems. In Norway and Sweden, exports have been especially hard hit because the euro has fallen in value against their currencies. But thanks to strong domestic demand, the Norwegian economy can steam ahead faster than that of its Nordic neighbours. We foresee Nordic GDP growth of about 1 per cent this year and nearly 2 per cent in 2013.

Japan in the grip of deflation

Japan's economic recovery is continuing, though at a modest pace. GDP growth will be more than 1.5 per cent in 2012 and a bit above 1 per cent in 2013. Very expansionary fiscal stimulus and reconstruction after the natural disaster last March are sustaining demand. The budget deficit is expected to exceed 11 per cent of GDP both this year and next. Government debt will grow to about 250 per cent of GDP next year. Even at the end of 2013 there will be plenty of idle resources in the economy, so deflation will remain endemic. Along with the extremely strong yen, this points towards further monetary easing.

Emerging Asia remains global growth engine

Economic expansion has eased in Asia's emerging market (EM) countries, but the region will remain an engine for the world economy. We expect the prevailing slowdown to end this spring. Growth will then accelerate again. Strong government finances and comparatively stable financial systems will make these economies resilient. Lower inflation will allow room for monetary stimulus measures. Some countries have already cut key interest rates, and more will follow in 2012.

Despite some deceleration, China's GDP climbed more than expected in the fourth quarter. Quarter-on-quarter, growth actually speeded up. A clear acceleration may occur this summer. We foresee GDP growth of more than 8.5 per cent in 2012 and nearly 9 per cent in 2013. Inflation has faded significantly in recent months, and the economic policy focus will thus shift from controlling inflation to supporting growth. Monetary policy has already been eased by lowering reserve requirements for banks, and further measures of this kind are ahead. There may also be reason for more expansionary fiscal measures.

India's growth and inflation have also slowed, giving the central bank reasons to lower its key interest rate. The first step may not materialise yet, however, since price increases remain rather high. Unlike China, India has weak government finances and thus cannot use fiscal policy to stimulate the economy. We expect GDP to increase by a bit more than 7.5 per cent this year and nearly 8 per cent in 2013.

Latin America will slow this year, accelerate in 2013

After last year's GDP growth of around 4.5 per cent in Latin America, we foresee a slowdown to about 3.5 per cent this year. After that there is a good chance of renewed acceleration both in the region as a whole and in its pace-setting countries – Argentina, Brazil, Chile and Mexico. Latin American inflation is falling today but will still end up at 6-6.5 per cent both this year and next. The Brazilian central bank in particular is likely to continue ratcheting down its key interest rate in 2012. Aside from interest rate cuts in various countries, Latin America is showing considerably better public budget and debt figures than many OECD countries.

Divergent economic patterns in Eastern Europe

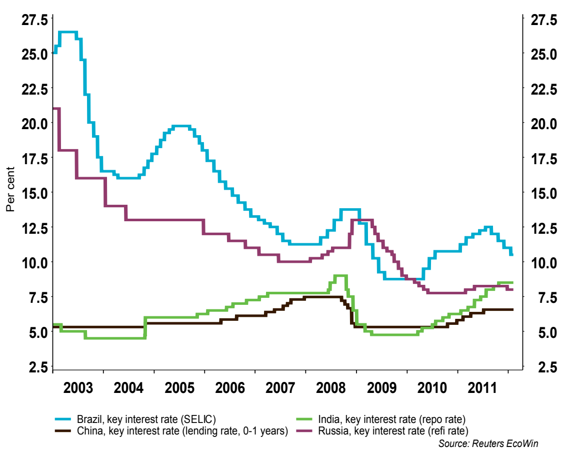
Eastern (including Central) European economies began losing momentum late in 2011. Exports and capital spending are now slowing, but consumption will hold up well in many countries, since household purchasing power will benefit from lower inflation. GDP growth will continue to weaken this year, but the pattern is uneven. Russia and Poland will cope with the euro zone crisis relatively well, the Baltic countries and the Czech Republic will manage decently, while Hungary and Ukraine will be among the hardest hit countries. These differences are due, among other things, to the size of exports and how dependent on banks in the euro zone these countries are.

Thanks to dynamic, competitive exports and previous aggressive budget-tightening, the Baltic countries have bounced back nicely after a deep 2009 recession. In the past year, domestic demand has started taking over after an initially export-driven upturn. The Baltic economies will grow by 1.5-2.5 per cent in 2012, and a little more next year. Their big current account deficits have largely been eliminated and their competetiveness has been restored. The three countries have also managed to stabilise public sector debt at a modest level.

Hope of global growth

After last year's figure of nearly 4 per cent, we expect global GDP (measured as purchasing power parities) to increase by 3.5 per cent in 2012 and 4 per cent in 2013. With growth figures of 5.5-6 per cent yearly, the EM sphere is easily ahead of the OECD countries, which will grow by an estimated 1.5-2 per cent. We have revised our growth forecasts for the world, the EM sphere and the OECD countries upward compared with our November 2011 estimates.

KEY RATE CUTTING CYCLE IN BRIC COUNTRIES



So far the Brazilian and Russian central banks have lowered their key interest rates in this cycle. It should not be too long before the People's Bank of China and the Reserve Bank of India follow suit. What has paved the way for a loosening of monetary policy in the BRIC countries is a combination of lower growth and fading price and cost pressures. Lower interest rates help sustain economic activity and make the BRIC countries more attractive for global investors.

Those who run too fast may easily stumble

Liquidity support to the financial system has put Modern Protection back on course, while risk appetite has given Growth and Aggressive a push. These portfolios remain positioned to benefit from better global economic conditions, while able to withstand most alternative scenarios.

MODERN PROTECTION

Throughout 2011, Modern Protection has been exposed to flows of returns that are fairly independent of economic trends. The inhibiting factor for the portfolio's returns has been the liquidity situation in Europe. Dwindling confidence between banks, with ever-higher interbank rates as a consequence, rising borrowing costs for the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) and worries about a euro collapse gradually increased liquidity risk during 2011.

To remedy this situation, the European Central Bank (ECB) offered and is continuing to offer unlimited three year loans at a low interest rate (1 per cent) to banks. This action has been well-received, and liquidity risk has receded. A new round of lending is also expected late in February.

The effect of improved liquidity in the financial system is highly visible in Modern Protection. During December-January the portfolio rose more than 1.5 per cent. Its returns are back on course after six months of anchor dragging. Our global macroeconomic picture is largely unchanged, and so are the positions in this portfolio.

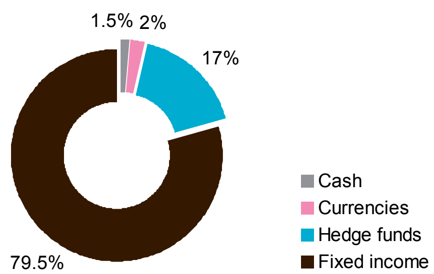
We expect inflation of around 2 per cent in most OECD countries. Meanwhile government bonds are at historic lows. German 10-year yields have been under 2 per cent since September 2011. Since government yields cannot fall below zero, interest rate risk is leaning more towards rising yields than the opposite, and the potential for generating real-term returns is becoming more and more difficult.

In the fixed income sub-portfolio, we thus continue to have 35 per cent in free mandates, with potential to generate returns even in environments of rising yields. High yield bonds account for less than 4 per cent of the sub-portfolio, and just below 6 per cent consists of leveraged loans, which can be described as high yield bonds, but with floating rates, which also have collateral in the respective company. Our allocation to emerging market (EM) bonds is still below 2 per cent.

The hedge fund sub-portfolio, which focuses on Multi-Strategy and Equity Market Neutral, continues to create stability in the portfolio. Since November, we have invested with a Credit Long/Short manager, whose return profile complements both our hedge fund and fixed income portfolios.

The currency sub-portfolio (2 per cent of Modern Protection) remains positioned according to our assessment that Asian currencies will appreciate against the US dollar. More normal risk sentiment in December and January caused currencies to again move on the basis of fundamental merits. The sub-portfolio rose nearly 2.5 per cent during these two months.

On the whole, we believe that the Modern Protection is well-balanced within its low-risk mandate. The primary risk lies in the market liquidity situation, which may deteriorate in the future. Basically, fundamentals should be in control again, and then the portfolio will recover in the way we have seen this winter. Our goal and strategy remain the same, and at the moment we are satisfied with our current allocation.



MODERN GROWTH

Since we wrote our last *Investment Outlook* in mid-November 2011, risk assets have recovered significantly. Worries about recession in Europe have not faded. Instead, the explanation is that the market has priced in meagre growth in Europe, and investors have become "tired" of being gloomy. We see two main factors behind strong financial market performance: 1) American macro statistics were better than analysts' expectations in December and 2) the European Central Bank (ECB) offered and continues to offer cheap three year loans (the Long Term Refinancing Operation, LTRO) to banks in unlimited amounts.

The first factor indicates that the US economy will continue to grow in 2012 as well, but our current assessment is that the momentum of the pace of surprises has begun to slow. Consumer confidence was somewhat lower, purchasing managers' indices were positive but somewhat lower than expected, private consumption was weaker and labour market statistics marginally weaker, to mention a few factors. There is thus an increased risk that US macro data may lead to downside rather than upside surprises.

The second factor, which we view as indirect "quantitative easing", has clearly reduced the liquidity risk in the banking system. Given reduced liquidity risk, assets can once again begin to be valued on the basis of more long-term fundamentals and markets can normalise. The ECB will carry out a new LTRO round late in February, probably easing pressure further and possibly improving risk appetite.

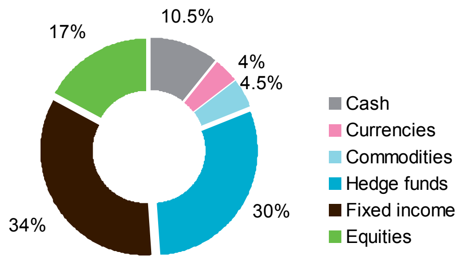
Although liquidity risk has decreased, the euro zone continues to face fundamental government debt and credibility problems. We will not see any solution for a long time to come, judging from the pace of political action so far. We can thus not rule out a renewed flare-up of worries about the euro zone this year. At this writing, for example, the spotlight has turned towards Portugal.

We have not made any dramatic reallocations between asset classes during the past six months. This is precisely because we do not believe that the global outlook has changed much. Meanwhile the political reform process in Europe is taking time. Since September, the equities sub-portfolio has been more selectively invested in Asia and the Nordic countries – the areas where we foresee the best growth potential. Equities have accounted for around 17 per cent of the overall portfolio throughout this period. In December, we reallocated global mandates for the purpose of reducing structural exposure to Europe. After these changes, the equity sub-portfolio is somewhat more positioned towards growth shares in the US and Asia, without having changed the portfolio's total exposure to equities. The outcome for the equities sub-portfolio in December-January was an upturn of nearly 7 per cent, with EM shares leading the way.

The fixed income sub-portfolio rose about 5 per cent during the same period. Within it, we have continued our exposure to high yield bonds, where we foresee the highest risk-adjusted potential returns. The yield gap against government bonds rose significantly under August-September as liquidity and credit risk rose, especially in the euro zone, but since then it has resumed its declining trend, which has benefited the portfolio. During January, the US dollar also began to weaken against EM currencies, which gave a push to our EM bonds listed in local currencies. The weaker dollar also benefited our currencies sub-portfolio, which rose about 2.5 per cent.

Commodities, which had a tough 2011, started better in 2012. Our commodities sub-portfolio rose 2 per cent during December-January. This asset class, which includes everything from orange juice to industrial metals and gold, is generally affected in the short term by the trend of the dollar, but in the long term by different driving forces depending on the commodity. Overall, we foresee modest upturn potential in our main scenario, but this asset class contributes to diversification and inflation protection, creating long-term stability in the portfolio. We are keeping our 5 per cent position.

The hedge fund sub-portfolio remains at about 30 per cent of Modern Growth, with a focus on CTA management strategies, which are based on mathematical models. Although at present these strategies have a tendency to move in the opposite direction compared to stock markets, they have the potential to change their positions when trends stabilise. During the most recent period, we have seen our CTA managers lose a little as markets have gone up, but on the other hand they have risen more sharply when markets have gone down – a characteristic that proved to be good during 2011. It is unclear whether the same strategy will be favourable during 2012, but we believe that our managers are capable of adapting their strategies if the underlying trend changes.

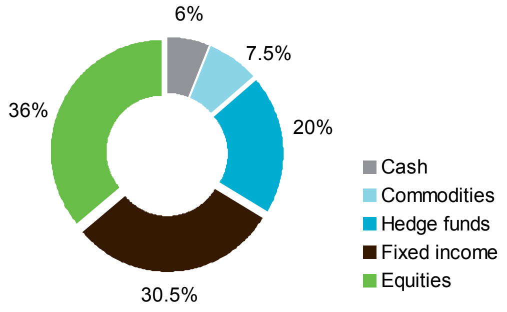


MODERN AGGRESSIVE

Risk appetite has risen sharply since September, with the VIX volatility index falling from levels of around 45 to below 20. We see indications that the trend towards ever-closer correlations between and within asset classes during 2011 has begun to reverse. Macro statistics, especially from the US, remain on the upside – with leading indicators signalling continued economic expansion. Increased risk appetite, lower correlations between different asset classes and a somewhat more stable macroeconomic picture have caused risk assets to climb since we wrote the last *Investment Outlook* in mid-November.

We have not made any dramatic reallocations between asset classes during the past six months. This is precisely because we do not believe that the global outlook has changed much. Meanwhile the political reform process in Europe is taking time. Since September, the equities sub-portfolio is more selectively invested in Asia and the Nordic countries – the areas where we foresee the best growth potential – and we have left these positions untouched. Equities have accounted for around 36 per cent of the overall portfolio throughout this period. Just as in Modern Growth, in December we reallocated global mandates for the purpose of reducing structural exposure to Europe. After these changes, the equity sub-portfolio is somewhat more positioned towards growth shares in the US and Asia, without having changed total exposure to equities. The outcome for the equities sub-portfolio in December-January was an upturn of nearly 7 per cent, with EM shares leading the way.

The fixed income sub-portfolio rose nearly 5.5 per cent during the same period. We have continued our exposure to high yield bonds, where we foresee the highest risk-adjusted potential returns. During January, the US dollar also began to weaken against EM currencies, which gave a push to our EM bonds listed in local currencies (about 5 per cent).



Commodities, which had a tough 2011, started better in 2012. Our commodities sub-portfolio rose 2 per cent during December-January. This asset class, which includes everything from orange juice to industrial metals and gold, is generally affected in the short term by the trend of the dollar, but in the long term by different driving forces depending on the commodity. Overall, we foresee modest upturn potential in our main scenario, but this asset class contributes to diversification and inflation protection, creating long-term stability in the portfolio. We are keeping our 7 per cent position.

The hedge fund sub-portfolio remains at about 20 per cent of Modern Aggressive, with a focus on CTA management strategies, which are based on mathematical models. Although at present these strategies have a tendency to move in the opposite direction compared to stock markets, they have the potential to change their positions when trends stabilise. During the most recent period, we have seen our CTA managers lose a little as markets have gone up, but on the other hand they have risen more sharply when markets have gone down – a characteristic that turned out to be good during 2011. It is unclear whether the same strategy will be favourable during 2012, but we believe that our managers are capable of adapting their strategies if the underlying trend changes.

Surprises may be waiting around the corner

- *There are many factors capable of invalidating our base scenario*
- *If growth is surprisingly fast, the main beneficiaries will be cyclical shares, commodities, EM debt and high yield bonds*
- *If Europe's sovereign debt crisis worsens, this will especially impact Western and Eastern European equities, bank shares and European high yield*

Just past the threshold to both 2011 and 2012, prices of equities and other risk assets climbed rapidly. Another parallel was that the VIX volatility index fell to levels (17-18) below the historical average – reflecting diminished uncertainty in financial markets and rising asset values. Early in 2011 the main reason for optimism was that the world economy was gradually shifting into a higher gear. Early in 2012 markets were cheered by surprisingly good economic statistics, especially in the US.

It began in the same way

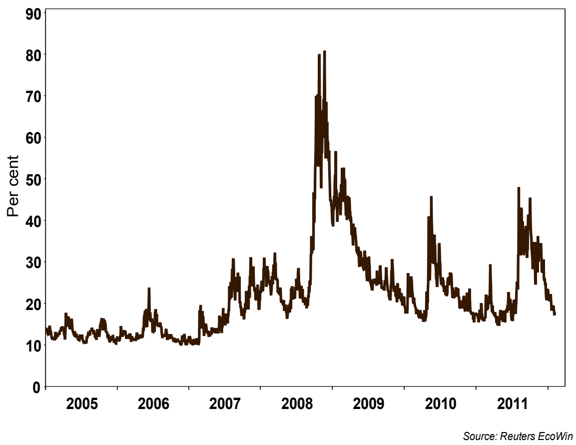
The 2011 and 2012 financial years thus began similarly. As for 2011, initial market optimism ran into trouble within two months. The main reason was escalating social unrest in the Middle East and North Africa (MENA). As a result, there was greater concern about disruptions in oil production, and oil prices soared. This pushed up world inflation, hurting the economy.

The next shock occurred on March 11, when Japan was hit by a natural disaster. The economic consequence was a steep drop in the Japanese economy, as well as major disruptions in deliveries of intermediate goods from Japan to the automotive industry in the US and elsewhere.

Worries piled on top of each other

Together these events cooled the world economy, which decelerated steeply during the second and third quarters. After a summer when the mood in the financial world was decent in spite of everything, a dramatic deterioration occurred early in August. What triggered it was the downgrading of the US sovereign credit rating by Standard & Poor's. There was also rising concern that the US would end up in recession and the Chinese economy in a hard landing. To top it all off, the European sovereign debt crisis escalated sharply, with Greece in the epicentre.

HISTORY IS REPEATING ITSELF



Both early in 2011 and initially in 2012, the VIX volatility index (see chart) was at historically low levels, which indicated a rather calm and positive mood in financial markets. Last year this calm was interrupted after a couple of months.

Economy and sovereign debt crisis set the tone

History thus shows that two main factors left deep impressions on markets last year: 1) a major economic slowdown, with an accompanying increase in economic worries due to higher inflation in the wake of rapidly rising commodity prices and the Japanese natural disaster, and 2) an escalating sovereign debt crisis in Europe, plus the fact that various countries elsewhere in the world saw their credit ratings downgraded, including the US.

By the end of 2011, however, optimism returned as a growing number of economic indicators delivered upside surprises – first in the US, and later in many other parts of the world. Early in 2012, some progress was also made in managing the debt situation in Europe. Taken together, these factors caused the markets to view financial risks as less serious.

Better starting position now than last autumn

Our base scenario for 2012 begins with a situation in which the world economy has recently stabilised and the risk of global recession has receded. Judging from this winter's many unexpectedly positive macro signals, there is also good potential for gradual strengthening of the economy this year. Continued ultra-loose monetary policies in influential industrial countries, coupled with unusually low sovereign bond yields, point in the same direction. Given this scenario, we believe that returns on various financial assets will turn out according to the table on page 6.

But what are the risks and opportunities that might lead to a better, or worse, economic scenario? And how would this affect the returns on various financial assets?

A balanced risk picture

Although major risks remain, the current economic picture for 2012 in the OECD countries seems balanced, after having had a clearly negative tilt last autumn. We are still assigning a 60 per cent probability to our base scenario, while the two alternatives – with upside and downside surprises, respectively – are now both considered to have a 20 per cent probability. In November, these probabilities were 15 and 25 per cent, respectively.

There is a long list of factors capable of invalidating our base scenario and changing the outlook for returns in a positive or negative direction, but the following factors are probably of special importance:

- Cyclical surprises generated by "inner forces"
- The unfolding of the European sovereign debt crisis
- A return of the inflation or deflation spectre
- Monetary and fiscal policy management
- Geopolitical events
- Unpredictable shocks, "black swans"

Fundamentally, the economy has its own rhythms. Left in peace, it may unfold in repetitive cycles with upturns that run for about 4-5 years and downturns that may run for a year or so. Yet the "inner forces" of the economy are hard to predict. Quite often, the growth rate in some part of the world suddenly begins to accelerate or decelerate, without anything important in the macro environment appearing to have actually changed.

But the economy is often not left in peace. Instead it is ordinarily subjected to constant influences from both positive and negative factors.

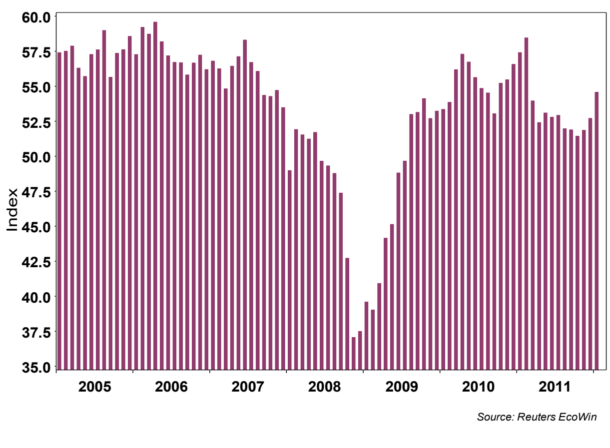
Sovereign debt crisis is an obstacle in many ways

A significant proportion of 2011 was dominated by the negative economic effects of 1) higher inflation, which undermined household purchasing power and 2) the European sovereign debt crisis. The latter was an obstacle to growth via two channels. The first was public budget-tightening and the second was negative financial market reactions, which soured the mood among households and businesses, with harmful effects on the economy as a result.

A majority of forecasters now apparently foresee the greatest potential for upside surprises in the US economy and the greatest potential for downside surprises in the European sovereign debt crisis. One natural reason is that both factors weigh very heavily, but another may be that these particular factors have dominated the analytical and media picture over the past few months. As recently as August/September 2011, however, there was great concern about a possible US recession. It is not unusual for historical events to be extrapolated into the future. But this does not automatically mean that these factors will be as important during 2012 as during 2011.

Price expectations may undergo violent movements

Higher inflation in the wake of sharp commodity price increases dominated 2011. This year, absent new dramatic commodity price rises, there should be a significantly calmer rate of price increases in both the OECD countries and the EM sphere. Lower inflation benefits household purchasing power and thus



THE ECONOMY IS SELDOM LEFT IN PEACE

The textbook image of an economic cycle is usually a sinus curve without dips, but reality seems quite different, as illustrated by the jerkiness of the JP Morgan global purchasing managers' index. Behind this is the recurrent existence of both positive and negative factors capable of influencing the economy.

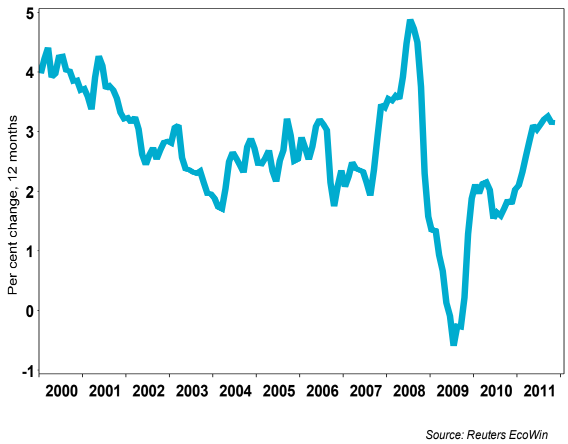
private consumption. It also paves the way for key interest rate cuts in those parts of the world economy where there is room to cut them, in other words mainly in EM countries, thereby stimulating the economy.

A clear slowdown in the inflation rate, or "disinflation", is of course our main scenario for 2012, but the past 3-4 years show that analysts and markets can sometimes have highly varied expectations about what will happen to prices. During and soon after the economic and financial crisis of 2008 and the first half of 2009, there was widespread concern about deflation (a general decline in prices). This was based on historical experiences that showed that economic crises with falling financial asset and property prices are sometimes followed by long periods of declining prices on goods and services as well.

This concern did not prove justified, however, and as early as the end of 2010 worries instead shifted to higher inflation, fuelled by substantially dearer commodities and massive quantitative easing by the US Federal Reserve in particular.

During 2012, by all indications the spectre of deflation will stay in its closet. Many OECD countries are admittedly in the midst of heavy-handed debt restructuring, but there are prospects of both an improving economic situation and higher financial asset prices within a year. The spectre of inflation will probably stay in its closet too, since wage and salary costs continue to rise very sedately in the OECD countries. Plenty of idle production capacity at companies and cautious banks will rule out an inflation fuelled by monetary expansion.

PRICES AND PRICE EXPECTATIONS – NOTORIOUSLY UNRELIABLE



Consumer price fluctuations in the OECD countries have been rather wide in recent years. As a result, expectations about which way prices are headed have shifted greatly. During 2008 inflation worries climbed, in 2009 the risk of deflation was the big topic of conversation. By autumn 2010 the danger of inflation was again fashionable.

Economic policy surprises are common

Official economic policy often provides surprises. For example, none of 63 fixed income analysts surveyed foresaw the first Brazilian key interest rate cut during 2011. The ECB's massive liquidity support to European banks in December was not expected either. Since the autumn of 2008 – after the collapse of Lehman Brothers – many central banks have also been forced to adopt unconventional monetary policy methods (quantitative easing, mainly bond purchases) once their interest rate weapon more or less ran out of ammunition. But the impact of these new monetary policy tools on the economy, financial systems and price formation is far from clear.

Another source of uncertainty concerns how much countries with budget deficits should tighten fiscal policies – on the one hand bearing in mind their very weak economies and widespread social unrest and, on the other hand, demands being made by lenders and international institutions.

The key question is how to craft a dose of fiscal austerity that, on the whole, does not hurt the world economy too much – an aspect emphasised especially by the International Monetary Fund (IMF) – while meeting the approval of lenders, thereby resulting in lower interest rates as well as less stress for heavily indebted countries.

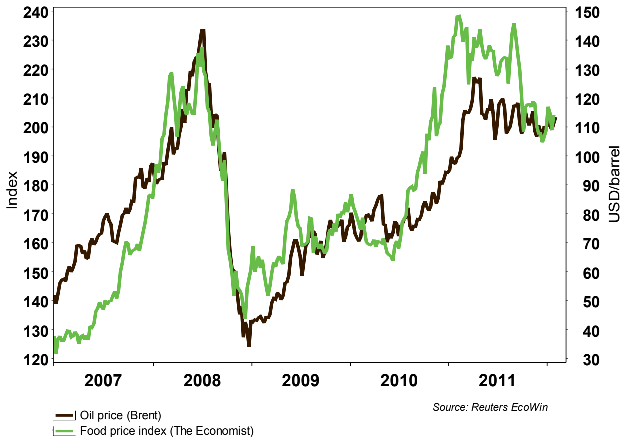
No one knows, and this is why the results of economic policies in OECD countries are likely to surprise analysts and markets in 2012 as well. Such surprises may also occur in the EM sphere, for example in the form of unexpectedly rapid interest rate cuts on a broad front, or a significantly more cautious use of the interest rate weapon than expected today.

The geopolitical world – a political variety store

The geopolitical world is packed with variety and also has a great capacity for surprises. One obvious example is the social revolt in the MENA countries – catalysed by a "black swan" in the guise of the fickle weather girl La Niña – which among things toppled totalitarian regimes, redistributed power and redrew political maps. The recent change of power in North Korea may serve as another example.

During 2012 tensions between Iran and the Western world, with the US and Israel in leading roles, might play a central part – especially if worries about oil production and deliveries lead to substantially more expensive oil. What will happen to the Assad regime in Syria is also high on this year's geopolitical agenda. Events there also have a bearing on the policies of the major powers, reflected in the Chinese/Russian veto of the UN Security Council's forceful resolution aimed at Syria.

Among other geopolitical factors this year will be general elections in some countries, which will probably have a major impact outside their borders as well, for example the elections in France, Greece and the US.



BLACK SWAN WITH DOUBLE IMPACT ON COMMODITIES

Early 2011 was dominated by major social unrest in North Africa and the Middle East, triggered by people's reactions to sharply rising food prices. Behind this price spike was steeply declining food supply due to the La Niña weather phenomenon – a "black swan" – which led to drought and fires in some parts of the world and massive rainfall and floods elsewhere late in 2010. Rising social unrest led, in turn, to growing worries about disruptions in oil production and caused oil prices to soar.

Black swans capable of great influence

As for black swans, by definition they are impossible to foresee or discover, as illustrated by dramatic weather events during 2010 and the earthquake and accompanying tsunami in Japan during 2011. Considering the size of their potential economic and financial effects, in any event these elusive black swans belong on the list of factors capable of influencing the economy and returns on assets.

Returns in our more positive alternative scenario...

How would returns on financial assets be affected by our more positive alternative scenario for 2012, set in motion by surprisingly high economic growth both in the US and globally?

In this scenario, all else being equal, markets will probably view sovereign debt problems as less worrisome, since higher growth will make the tough debt restructuring work of many countries easier.

Compared to our base scenario, equities should generally provide higher returns, with special advantages for cyclical companies and perhaps banks. Geographically favoured regions are the US, the Nordic countries, Asia excluding Japan and Latin America. Eastern European shares would certainly enjoy far more positive leverage in a scenario of significant progress in managing the government financial problems of Western Europe.

Returns on commodities, especially industrial metals like copper, and the value of commodity-related currencies would be higher than in our base scenario – Russian equities should perform better than the Eastern European average – and emerging market debt would be among the winners. High yield and other corporate bonds would also enjoy clear advantages. Among the losers would be sovereign bonds of core OECD countries, probably also beaten by the government securities of Europe's problem countries.

...and returns in our more negative scenario

Finally, what would happen to returns on financial assets in our more negative scenario for 2012, dominated by recession in both the OECD countries and globally, and triggered mainly by an escalating government financial crisis in Europe?

Equities would be generally characterised by falling prices, with the biggest downside risks for financial shares. Geographically, Western Europe would be hurt the most, followed by Eastern Europe. Corporate bonds – especially European high yield – would experience a lost year, together with southern European sovereign bonds. Most commodities and commodity-related currencies would fall in value, as would the euro and Eastern European currencies especially.

Among the winners would probably be sovereign bonds in countries like the US, the UK, Norway and Sweden, and in the foreign exchange market the USD and JPY. The CHF does not belong on this list if it remains pegged to the EUR. Real estate may possibly be viewed as a fairly safe asset, and gold would presumably attract many worried investors – despite a far greater risk of deflation than inflation in this scenario.

Theme

Protecting oneself against a euro collapse

- *A euro collapse would lead to deep recession*
- *Capital market reaction would be more dramatic than after the Lehman Brothers crash*
- *Portfolio protection can prevent a sharp decline in value*

As the debt crisis in southern Europe worsens and the cracks in the euro project become ever deeper, the existence of the euro has begun to be questioned. A couple of years ago it was unthinkable that a country could abandon the euro, but today an open discussion on this theme is under way. Although our main scenario is that the euro will remain intact and no countries will leave the common currency, it is worth pondering the possible effects of a potential euro collapse. In this theme article, we will try to predict how different asset prices may react, as well as how investors can protect themselves if the euro project breaks up.

Worse outcome than the Lehman Brothers crash

By all indications, a euro collapse would lead to a financial and economic meltdown larger in magnitude than when the American investment bank Lehman Brothers crashed in the autumn of 2008. There was a total element of surprise when US authorities, having saved several other financial institutions teetering on the brink of ruin, chose not to save Lehman Brothers. Fear spread like wildfire among financial market players. The financial system tied itself in knots, since no one wanted to end up being the loser. Liquidity was hoarded, instead of flowing like oil through the financial machinery. Predictably, the wheels of the real economy also began to squeak as businesses and households were denied financing.

The euro project is in severe crisis today. There are major tensions between countries, political leaders and voters. If politicians' attempts to steer the euro through the crisis should fail, there is a risk that the currency will not survive in its current form. There are many conceivable outcomes, with widely varying market implications. One outcome of a gentler nature would be if the most crisis-plagued countries abandoned the euro and converted to their own currencies. But even such a scenario would cause major strains in the financial system. It might also lead to market uncertainty, on the theme "Whose turn is next?" A country that had left the euro zone would of course improve its competitiveness, since the value of its own currency would be far lower than the euro, but this is no solution to the euro problem. This country would still be forced to implement tough reforms, and the remaining euro zone countries would have to keep working towards greater collaboration and eventually a political and fiscal union. Given this outcome, the element of market surprise would still be far less than if the entire euro project were dissolved.

A decision to completely dissolve the currency union would be unexpected and would profoundly shock the market. The element of surprise would be a necessity, since the alternative – announcing a future date in advance – would immediately lead to enormous capital flows away from weak countries and banks to strong ones. These flows would cause a financial meltdown that would be impossible to control. But even if the break-up decision were kept secret until the last minute, the economic consequences would likely be deadly.

Dissolution of the euro project and conversion to 17 new exchange rates would be far from a problem-free exercise, especially since it would have to occur quickly and probably in a climate of great financial uncertainty. Banks would probably assume a very cautious attitude towards lending to both businesses and households, until they knew where the risks were. The Lehman Brothers collapse taught us that risk identification takes time. To avoid relying on a fragile banking system, companies would probably build up cash reserves and households would be reluctant to open their wallets. A combination of liquidity shortages and plunging corporate capital spending and private consumption would lead to large-scale economic paralysis. The "former" euro zone could not avoid deep recession, and this too would also have a major impact on the global economy.

The behaviour of different asset classes

What, then, could we expect from the market in this nightmare scenario? Generally speaking, riskier and less liquid assets would perform worst in a stressed market climate. Equities and commodities are typical risk assets that would be among the big losers. In the stock market, smaller markets generally also take more of a beating than bigger ones. Thus, for example, the US stock market usually manages better than those of the Nordic and EM countries in case of a stock market crash.

In the commodities market, it is usually cyclical commodities – oil and industrial metals – that see the largest price declines in a stock market crash. Agricultural prices are significantly less sensitive to changes in the economy and would thus not be affected to the same extent. Precious metal prices are a little trickier, though. Gold is often viewed as a "safe haven" investment, but in case of extreme financial market disruptions – which a euro collapse would cause – it is more doubtful whether gold could resist being pulled along.

The bond market is far more diversified. In general, the government bond market strengthens when the economy slows, while corporate bonds lose value. The worst performers are corporate bonds in the high yield segment (issued by companies with low creditworthiness). The less risky investment grade segment usually manages better, but also loses value as investors become less willing to take risks.

In the foreign exchange market, the most liquid currencies manage the best when risk appetite is conspicuously absent. The US dollar (USD), Japanese yen (JPY) and Swiss franc (CHF) usually gain ground in troubled times, but today the CHF is pegged to the EUR. Smaller, cyclically sensitive currencies such as the Swedish krona or Norwegian krone, however, usually take a big beating when risk appetite fades.

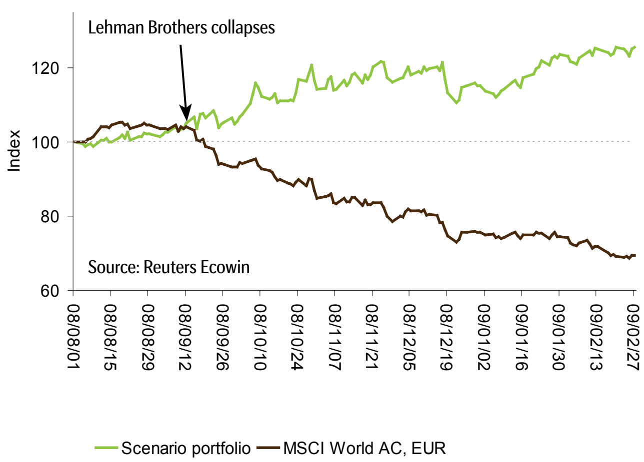
How do we protect ourselves from a euro collapse?

If we assume there is a risk that a euro collapse may occur – and that this would have a devastating impact on financial markets – what can we do to protect ourselves?

One way is to create a portfolio of assets that are usually resilient in troubled times. This portfolio may account for a certain percentage of our total investment capital, with the rest being invested according to our individual risk appetite. Allocation ratios would be determined by how large the probability of a euro collapse is deemed to be.

In order to identify suitable holdings for a protective portfolio in a negative scenario, we have chosen to look back at how financial markets performed during the 2008 crisis. This leads us to the conclusion that we should own US dollars, Japanese yen and Swiss francs or gold. The safest is probably to have a diversified portfolio of all these assets in order to minimise risks. What effects a euro collapse would actually have, how political leaders would choose to tackle it and what the market would discount are three factors we cannot fully predict and that would affect market performance.

As an illustration, if we create an equally weighted "scenario portfolio" of the above-mentioned assets (USD, JPY, CHF and gold) and look at market performance from August 1, 2008 to February 27, 2009, it turns out that while the MSCI AC World Index of equities (in euros) fell 31 per cent, our scenario portfolio rose by a full 26 per cent.

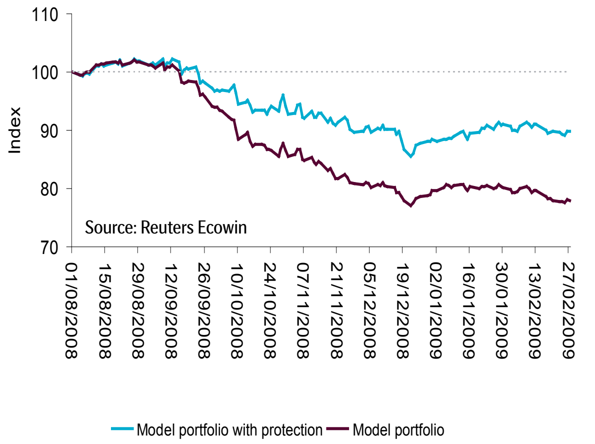


STRONG PERFORMANCE FOR "SCENARIO" PORTFOLIO AFTER LEHMAN BROTHERS COLLAPSE

An equally weighted portfolio consisting of US dollars, Japanese yen, Swiss franc and gold rose 26 per cent between August 1, 2008 and February 27, 2009, measured in Swedish kronor. During the same period, the global stock market fell 31 per cent.

Let us now look at a "model portfolio" and assume we have a neutral allocation. At present, a typical allocation is 30 per cent global equities, 25 per cent fixed income securities with an overweighting of corporate bonds and 45 per cent alternative investments (20 per cent hedge funds, 10 per cent commodities, 5 per cent private equity, 5 per cent real estate and 5 per cent currencies). Such a portfolio lost around 22 per cent of its value during the above period. If we had protected the portfolio by allocating 25 per cent of its capital to the above-mentioned scenario portfolio, total performance would instead have been -10 per cent.

PORTFOLIO PROTECTION CAN PREVENT A SHARP DECLINE



The Lehman Brothers crash helped trigger a sharp decline for the model portfolio we have described. If, at the time, we had chosen to protect this portfolio with a 25 per cent allocation to an equally weighted "scenario portfolio" consisting of US dollars, Japanese yen, Swiss francs and gold, it would have prevented this decline.

What does it cost to protect oneself?

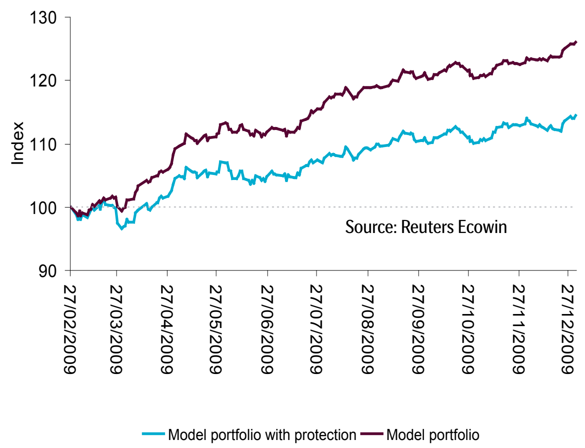
With the help of an allocation to our scenario portfolio, we thus succeed in preventing sharply negative performance in our model portfolio. What, then, is the cost of this protection? Or in other words, how would the scenario portfolio perform in a more positive market climate?

A more positive climate should reasonably lead to greater risk appetite, which generally speaking should cause both the USD and the price of gold to fall. However, gold has performed strongly in recent years, both during cyclical reversals and advances. For this reason, today it is very difficult to predict the direction of gold prices in a more optimistic scenario. The nature of the catalyst that strengthens the economy will probably also be crucial in determining where gold prices are headed.

We will attempt to estimate the cost of this protection by looking at the above portfolios in a significantly better market climate. One year that offered decent returns on most risk assets was 2010. Let us look at the performance of the model portfolio from January 1 to December 31, 2010. After that we will carry out the same exercise as before, allocating 25 per cent to the scenario portfolio and keeping 75 per cent in the model portfolio. In this case, protection does not turn out to be a cost at all, but quite the contrary. Whereas the model portfolio gained 13 per cent, the protected portfolio rose 14.5 per cent. One big reason for this was that gold performed surprisingly well (+32 per cent measured in euros) in the positive market climate we saw during 2010. We can speculate as to whether the price of gold would increase as strongly in an optimistic market today, but we should be cautious about making such an assumption.

If market performance should be better than in 2010 – say, as good as between March 1 and December 31, 2009 – we would lose a full 12 percentage points in returns by using the above portfolio protection. Our portfolio would increase by 14 per cent, instead of 26 per cent. At present, it is certainly not so likely that we will experience a stock market rally like the one we saw in 2009. But our study provides a sense of how large the cost of the proposed protection might conceivably be.

IN A STOCK MARKET RALLY, PROTECTION MAY BE TOO EXPENSIVE



During the stock market rally from March 1 to December 31, 2009, the model portfolio climbed 26 per cent in value. If we had allocated 25 per cent of our capital to the scenario portfolio during this period, the total portfolio would instead have climbed by only 12 per cent.

So does it make sense to put this protection into our portfolio? The answer is highly individual and ultimately depends on what risks we are willing to take as investors. If we have a long investment horizon and the thought of a euro collapse does not keep us from sleeping at night, we can probably do without this protection. If the situation is the opposite, we should certainly give some extra thought to how we can achieve suitable protection against the worst conceivable scenario.

Pros and cons of the early 2012 rally

- *Stock markets soared early in 2012 – a false start?*
- *ECB is providing unlimited loans to European banks*
- *Western economies must balance budget restraint and stimulus*

In advising clients on how to invest their capital, we are always weighing future returns against capital preservation. Markets have fluctuated as investors have worried about things like US economic growth, the European debt crisis and a possible hard landing in China. We believe recent history is likely to repeat itself, and we see no clear direction materialising in equity markets.

This year might bring more clarity to the markets, but because the recent short-term rally is coupled with high uncertainty, we remain cautious towards equities as an asset class.

Markets have started off 2012 on a positive note. The best performers so far have been some of the BRIC countries, with India leading the way (+11 per cent year-to-date) followed by both Brazil and China (+9 and +8 per cent, respectively). The US seems to be continuing its December rally and so far is up 5 per cent YTD, while Europe, Japan and Russia are the laggards, but even these countries are showing positive performance ranging from 3-5 per cent YTD.

Within the euro zone there is a wide discrepancy between countries. Germany has delivered a solid performance, with the Frankfurt Stock Exchange up about 7 per cent YTD, while problem-plagued Portugal and Spain are both in negative territory for the period.

Sectorwise, the "risk on" sentiment has resulted in investors buying mainly into last year's losers, namely banks and financials. So far this year, these two sectors (measured by the broad EuroStoxx index) have climbed nearly 10 per cent, while historically defensive sectors like telecoms and health care have turned in a negative performance early in 2012.

There is currently a tug-of-war between a set of positive drivers that have been around for a while and a mix of long-term negatives (such as the indebtedness of the Western world) and some warning signals in short-term indicators.

Positive	Negative
Valuations	Indebtedness and lack of growth
Low yields – favouring equities	Bank balance sheets
Awareness by central bankers/ politicians	Volatility already at low levels
Corporate balance sheets	Sentiment indicators too high

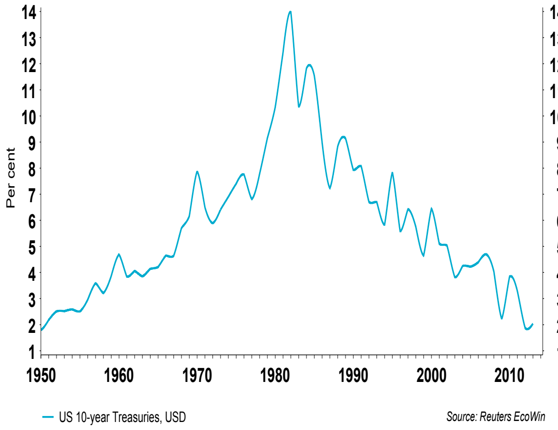
Valuations: As mentioned in many previous issues of *Investment Outlook*, current valuations in equity markets are fairly cheap in a historical perspective. In terms of both price/ earnings (P/E) and price/book value (P/BV) ratios, most equity markets are valued well below historical averages, with a solid upside potential.

Index	P/E 2011	P/E 2012E*	P/E 10-yr median	P/BV 2011	P/BV 2012E*	P/BV 10-yr median
S&P 500	13.2	12.8	17.9	2.01	1.98	2.72
Germany	10.2	10.7	17.6	1.22	1.29	1.59
Sweden	11.0	13.1	16.0	1.72	1.85	2.57
Finland	12.8	14.9	16.4	1.31	1.46	2.30
Norway	10.7	10.1	11.9	1.30	1.28	1.60
Denmark	15.8	14.4	14.8	1.67	1.72	2.13

*All Nordic key ratios are based on aggregate figures (market cap) in SEB Enskilda's Nordic equities universe. * = estimate.*

Low yields benefit equities: In a financial landscape screaming for returns, plummeting yields on what used to be (and to some extent still is) one of the most risk-free investments on earth, US government bonds, is in itself encouraging investors to take on more risk in trying to generate returns, thereby increasing their exposure to equities.

US GOVERNMENT BOND YIELDS AT HISTORICALLY LOW LEVELS



The extremely low yield offered by the US Treasury securities market is encouraging investors to take on more risk in their search for returns. One way they do this is by increasing their exposure to equities.

Central bankers and politicians have gradually moved the economic situation in Europe higher up on their agenda. They are now dedicating time and resources to an effort to craft solutions that will make political stability and economic growth return to this region. Awareness of the gravity of the crisis and its possible implications seems high among European leaders. This is not to say that everything will be resolved in an orderly manner, but as far as commitment and involvement goes, it is fair to say that European leaders are certainly addressing the issues at hand.

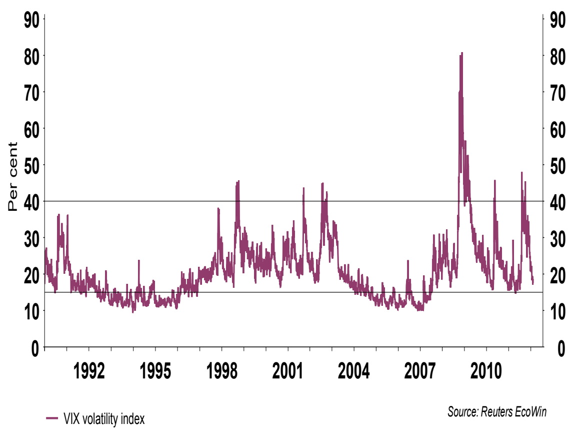
Corporate balance sheets are, to a certain extent, in better shape than during the 2008 crisis. For US non-financial corporates, cash as a percentage of total assets (currently 6 per cent) is at its highest level since the 1950s, having bottomed out at 3 per cent during the early 1980s. Worth noting, however, is that the ratio of total debt to net worth has only fallen to just below 50 per cent, while peaking at 56 per cent in the aftermath of the financial crisis.

Indebtedness and lack of growth: One of the factors contributing to a negative view on equities is the massive accumulation of sovereign debt among Western nations. Not only does the magnitude of current debt require stricter budget discipline – but even more importantly, it prevents individual nations from acting contra-cyclically in order to stimulate future economic growth. The situation is dramatic for many European nations, and although January bond auctions went according to plan, there is still a risk related to sovereign debt rollover. Almost 50 per cent of Italy's debt that matures in 2012 falls due during the first four months. Ten-year yields in Italy and Spain are currently trading at 6.10 and 4.75 per cent respectively, while Portugal's 10-year yield rose from 11.8 to 14.5 per cent in the last two weeks of January.

European banks are not in good shape and have been temporarily bailed out by the European Central Bank through its Long Term Refinancing Operation (LTRO) programme. Within LTRO, European banks can receive three year funding through the ECB at a 1 per cent interest rate. Demand for the "first tranche" of ECB funding in last December reached EUR 490 billion, greatly exceeding estimates. The French prime minister declared that it was now the responsibility of banks to use ECB funding to prop up their governments (i.e. buy sovereign debt). The problem is of course that this funding is not an additional source of capital, but rather a substitute for traditional funding from the previous sources. US financial institutions, Asian governments and sovereign wealth funds have become wary of lending to European banks while the debt crisis persists. The implications are that this financial stimulus is largely being trapped in the banks' own balance sheets, rather than being re-lent to the corporate sector to stimulate growth.

Volatility, measured by the VIX index (implied volatility of S&P 500 index options) is often referred to as the fear index. The VIX is a measure of investor sentiment and has historically traded between 15 and the high 40s. Having spiked at 48 during last year's equity market turbulence, the index has fallen at a steady pace and was at 18 early in February.

VIX INDICATES SHARPLY HIGHER RISK APPETITE

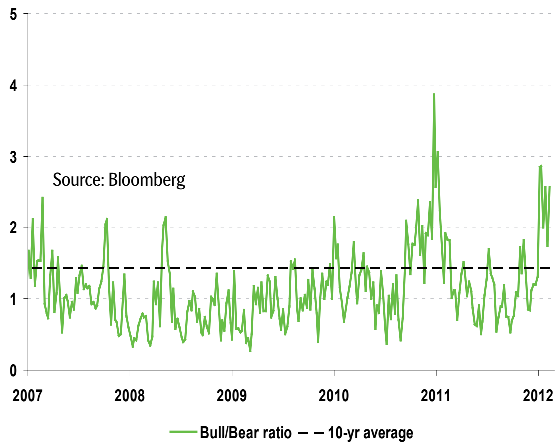


Since last year's stock market turbulence, risk appetite has increased in the market. This is reflected, not least, by the decline we have seen in the VIX volatility index, which dropped from last autumn's peak of 48 to around 18 in early February.

This is of course an indication that investors are less troubled than 6 months ago, but we fear that these levels are much too low and that investors are far too fearless. As the chart on the preceding page indicates, the current level has too often been an indication of a sentiment turning point.

Sentiment indicators are too high: On the back of low levels in the VIX index, the Bulls/Bears ratio among US investors spiked dramatically during January. Investors are clearly starting 2012 on a positive note and are hoping for solutions in Europe, continued positive surprises in the US economy and a soft landing in China. We fear that current ratios, in a historic perspective, are pricing in too positive a scenario.

MANY INVESTORS ARE EXPECTING A CONTINUED STOCK MARKET RALLY



The percentage of investors with a favourable market view climbed sharply early in 2012. This indicates higher expectations, with more and more market players pricing in a far more positive scenario ahead.

Weighing together the pros and cons, we end up concluding that conditions are favourable for the stock market but that because of the rally of recent months, a lot of this upside is already priced in today. The 2012 stock market year has good potential to end well above zero, but investors should be prepared for a bumpy ride.

Our stock market model for country allocation

The acute situation in the euro zone has calmed somewhat. Other factors besides the debt crisis have thus begun to have an impact on asset prices. For example, rising share prices in recent months can essentially be ascribed to surprisingly strong economic growth in both the US and China. As a recurrent feature of *Investment Outlook*, we are presenting our stock market model for allocation between different countries and regions. With the euro zone crisis no longer overshadowing all other factors, the model may serve as a useful regional allocation guide. As always, however, it is important to emphasise that a model is always a radical simplification of reality.

The model should be regarded as a tool to explain how we see various markets and what we believe will drive them.

Not so much has changed in our view of the market compared to the last issue of *Investment Outlook* (November 29, 2011). We thus believe that the same factors as before have the potential to drive the stock market from a country perspective. These factors are GDP growth, monetary policy, fiscal policy, financial stability, valuations and currency. Each factor is assigned a score based on its positive or negative contribution to the stock market in each respective country. The scores vary from -3 to +3.

China and the Nordics still on top

Once again, China scores highest in our model. Many of China's attributes also apply to Asia in general. The region's high growth is no secret. But at a time when global economic growth is below its historical trend, investors will probably take increasing notice of the wide growth gap prevailing between Asia and the Developed Market (DM) countries.

As a consequence of falling food prices, previously high inflation pressure in Asia has eased, which should benefit stock markets in several ways. Household purchasing power is rising, especially since food costs generally account for a large proportion of total Asian household consumption. Lower inflation opens the way for more expansionary monetary policies. While key interest rates in the West have already parked close to zero, the interest rate weapon is fully loaded in the East. If economic activity dwindles to an undesired extent, China can also flex enormous fiscal muscles. Looking at the "financial stability" factor, the country gets a top score. Its trade surplus is the world's largest and its government debt is low. Looking ahead, there are also many indications that Asian currencies will appreciate (see the Currencies section).

The Nordic countries and Russia also perform well in our model, and there are similarities with Asia and China on many levels. It is difficult to compete in terms of growth rates, but the financial health of the Nordics and Russia is good and there is room to adopt more expansionary fiscal and monetary policies. Another similarity is that stock markets in these countries also performed weakly during 2011. In our view, these markets took an undeservedly heavy beating. One reason for their weak performance is that investors still view the EM sphere and the Nordic countries as peripheral markets, into which they are reluctant to put money if market conditions are stormy. But in 2012, these stock markets have made a comeback, though there is still a risk premium for small stock markets that should gradually shrink.

Southern Europe not worth the risk

The euro zone has confirmed its bottom ranking in our model. The region earns positive scores because its stock markets are cheap from a valuation standpoint and because monetary policy can be regarded as highly expansionary. The ECB recently supplied about 500 banks with nearly EUR 500 billion, facilitating their refinancing needs and enabling the market to write off the risk of liquidity shortages in the banking system. But otherwise, a lot of things are still weighing down the euro zone. The curves are continuing to go in the wrong direction for southern European economies, and we are sticking to our forecast that the euro zone is moving towards a mild recession. The biggest source of uncertainty, however, remains the political scene. Although several important steps have been taken towards greater collaboration, there are still major tensions between nations, political leaders and voters. Several stock markets in the region may very well rebound sharply if political development bring upside surprises, but we do not believe this risk is worth taking. Meanwhile conditions vary greatly between northern and southern Europe. Germany's economic vitality, for example, has been an upside surprise in the past month, and the euro's weak exchange rate is fuelling the country's important export sector. Exposure to German companies thus has the potential to be a favourable investment.

OUR REGIONAL ASSESSMENT MODEL

COUNTRY/ REGION	Growth	Monetary policy	Fiscal policy	Financial stability	Valuations	Currency	Total
China	2	2	2	3	2	1	12
Russia	1	1	2	2	2	1	9
Nordics	-1	2	2	2	2	2	9
Brazil	1	2	1	0	-2	1	3
India	2	1	0	-1	0	1	3
US	2	1	-1	-1	0	1	2
Japan	0	0	-1	-1	2	0	0
Euro zone	-2	2	-2	-1	2	-1	-2

In our stock market model for country allocation, we select those factors that we believe will set the tone, based on the market climate we see before us. Each factor is assigned a score based on its positive or negative contribution to the stock market in each respective country or region. The scores vary from -3 to +3. This time around, we believe that the following factors can generate different potential for various stock markets: GDP growth, monetary policy, fiscal policy, financial stability, valuations and currency.

Companies financially healthier than governments

- *While governments have become financially weaker, companies have instead gained strength...*
- *...which is the basic reason why corporate bonds are more attractive than sovereign bonds*
- *Pricing of high yield bonds also reflects an overly pessimistic economic scenario*

Government bonds have traditionally been regarded as "safe" fixed income investments, followed by mortgage and corporate bonds in ascending order of risk, but in recent years there have been rather dramatic reasons to reassess this view.

It began when the US mortgage financing bubble burst in 2007, as reflected in the bankruptcies of numerous mortgage institutions operating in the sub-prime sector (specialising in loans to economically weak households). In the wake of these bankruptcies, there were sharp declines in the prices of mortgage-backed securities, followed by the most severe global financial and economic crisis in living memory. Several European countries were meanwhile hit by real estate crises, which dealt a heavy blow to many mortgage lenders on this side of the Atlantic.

This continued with a tumultuous sovereign debt crisis centred in Europe, leading credit rating agencies to downgrade the securities issued by many governments, in a number of cases to "junk" status. For good reasons, the sovereign bonds of many countries and – to some extent – their mortgage bonds have thus lost much of their previous status as safe fixed income investments. When the US lost its AAA credit rating from Standard & Poor's in early August 2011, this contributed to the markedly negative market mood during August and September. Today only 15 governments in the world boast this top credit rating. They include Germany, the United Kingdom, Switzerland, Norway, Sweden, Hong Kong and Chile.

The outlook for government finances does not seem good. This is especially true of the various problem countries of Europe, but also the US and Japan. These countries face many years of tough spending cutbacks, as well as tax and fee increases, in order to reduce their large budget deficits and slow the growth of their accumulated debt. Put differently, fiscal policy in numerous OECD countries will have a tightening bias for many years – regardless of the prevailing economic phase. In other words, there is practically no room in many countries for traditional Keynesian stabilisation policy using fiscal stimulus measures.

Heavy responsibility for central banks

Economic policy responsibility for helping sustain the economy and the financial sector is thus falling heavily on central banks. The US Federal Reserve (Fed) served as a role model by quickly beginning to apply a "zero interest rate" policy, as well as launching massive quantitative easing (QE) measures: purchases of government and mortgage-backed bonds.

The Fed has also started to use a communicative monetary policy weapon. The "bullet" from its last interest policy meeting in January was a promise that the prevailing 0.25 per cent key interest rate would probably apply until late 2014. In our judgement, the Fed may also launch a third round of quantitative easing (QE3) later this year.

Like the Fed, the Bank of Japan has carried out large purchases of securities (aside from government securities, also corporate bonds and equities). The Japanese key interest rate is generally expected to remain at 0.10 per cent for several years. The Bank of England's key interest rate will be parked at 0.5 per cent for a long time to come, and the ceiling for BoE bond purchases was raised early in February from GPB 275 billion to GBP 325 billion.

The ECB – an outlier

Unlike its other major colleagues, the European Central Bank (ECB) raised its refi rate in two steps to 1.50 per cent during spring and summer 2011. During the autumn, it reversed course and cut the key rate to 1 per cent again. The rate is likely to remain at that level at least until 2014. Meanwhile the

ECB is continuing to supply European banks with unlimited liquidity and is buying the bonds of euro zone problem countries in the secondary market.

During 2012, government bond yields in such core countries as the US and the UK will be affected by contradictory forces. Large financing needs and prospects of slightly better risk appetite point towards higher yields, while much lower inflation and central bank bond purchases are arguments in favour of lower yields. Our bottom-line forecast is somewhat rising yields on government bonds in the course of the year.

Concurrently with the financial deterioration of many governments in the past several years, the situation for companies worldwide – and thus for the bonds they issue – has improved in various respects.

Corporate profits are determined, among other things, by demand for the goods and services that companies produce, the expenses charged to their income statements and how efficient their production is.

The world economy is indeed now in a slump, but it is predicted that by summer 2012 this will be followed by gradually higher growth and demand. Wages and salaries – the largest expense item at many companies – are still increasing slowly, due to weak labour markets. Together with continued fairly good productivity (production per hour worked), this will result in very minor increases in expenses per unit produced, which is incidentally the most important factor behind inflation in the OECD countries. In addition, the sharp upturn in commodity prices late in 2010 and early in 2011 has been followed by falling prices, lowering production costs for companies all over the world.

Profits a rising share of national income

Meanwhile the financial health of companies has strengthened in several dimensions. The profits from each product sold have reached almost record levels in most places around the globe. In the US, corporate profits (earnings per share for companies in the S&P 500 equities index) have grown by an average of about 8.5 per cent annually over the past 20 years, nearly twice as fast as the country's GDP growth. As a share of US national income, they have thus increased from around 34 per cent at the turn of the millennium to more than 38 per cent in 2011. By all indications, this trend will continue during the next several years.

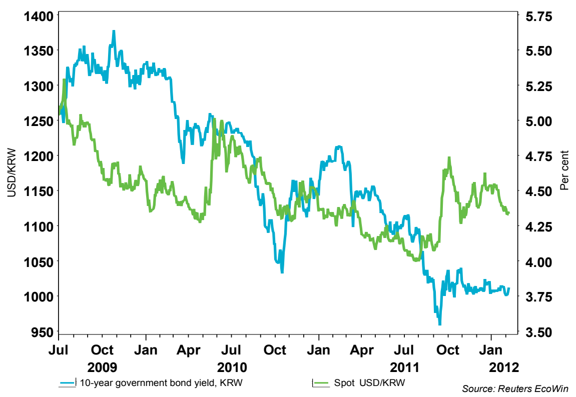
Corporate balance sheets have also become stronger and more stable. Debt has fallen and many companies have extended the maturities of their bond loans, lowering the risk of defaults and bankruptcies. In addition, corporate treasuries have aimed at building up a larger reserve of liquid assets. This has given companies a buffer in case of unexpected and adverse changes in their business environment. As a consequence, the danger of suffering a liquidity crisis has decreased.

Among companies that issue high-yield bonds, the bankruptcy figure in January 2012 was 2.0 per cent, compared to 2.8 per cent a year earlier and 13.6 per cent in November 2009 (the peak during the financial and economic crisis). Although Moody's credit agency predicts that the bankruptcy level will climb above 2.5 per cent in January 2013, this is well below the average since 1983 (5 per cent).

Companies financially stronger than governments

To summarise, today companies are often economically and financially stronger than many governments. In many cases, companies are also more financially robust than mortgage lenders. This is the fundamental reason why corporate bonds – especially high yield – are attractive to investors.

In addition, the pricing in the high yield bond segment indicates that the world economy will soon end up in a major recession, which is not our assessment at all. Given the prospects of slightly better economic performance and a gradual rise in risk appetite in financial markets, the wide yield gap between corporate and government bonds should shrink – resulting in price increases for corporate bonds.



EM DEBT WELL PLACED IF RISK APPETITE RISES

When the mood improves in financial markets and the desire to choose riskier investments increases, emerging market debt is well positioned. For an investor in the OECD countries, the return on such investments comes primarily from rising exchange rates for EM currencies, but also to some extent from price gains on EM bonds. The adjacent chart shows data from South Korea. During the third quarter of 2010 and the second quarter of 2011, for example, the Korean won rose at the same time as the bond yield fell/bond price rose.

Europe – headache and hope for managers

- *Liquidity support to banks improves the risk environment...*
- *...and potential for Relative Value*
- *Macro and Trading still the best diversification*

Since the last issue of *Investment Outlook* (published November 29, 2011), hedge fund performance has remained negative. At the risk of repetition, the main reason is the euro zone crisis. Perhaps worth adding are some concerns related to the economic slowdown in China and downgrading of credit ratings for banks and various euro zone countries. Unlike the last *Investment Outlook*, we can note that macroeconomic statistics from the US have been positive for risk appetite. The HFRX Global Hedge Fund Index lost 0.5 per cent during the fourth quarter of 2011. This was significantly better than in the third quarter, when the index lost 6.45 per cent. For 2011 as a whole, the decline was 8.9 per cent.

All major strategies showed negative results in 2011, with Equity Hedge performing the absolute worst with a downturn of 19.1 per cent. Macro and CTA again showed relative strength by losing only 1.8 per cent during the same period. As in previous issues of *Investment Outlook*, we are choosing to divide the hedge fund market into four main strategies:

- Equity Long/Short
- Relative Value
- Event Driven and Distressed
- Macro and Trading

Equity Long/Short

Although stock markets generally rose somewhat during the last three months of 2011, great uncertainty prevailed. Volatility was thus high. Contradictory and confusing statements about economic prospects and solutions to the euro zone's problems did not help create stability. In the real economy, the US recovery received further support from macro data that provided upside surprises. Managers consequently reduced their total exposure and thus did not benefit either from the stock market's overall positive performance during the quarter. HFRX Equity Hedge lost 0.9 per cent in the fourth quarter of 2011, while HFRX Market Neutral rose 0.6 per cent. For the full year, their final figures were -19.1 per cent and -2.9 per cent, respectively.

The continued debt crisis and expectations of poorer corporate profits are likely to have a continued negative impact during the first quarter of 2012. The probability of a recession in the euro zone has increased, and support for this view is visible in prices, which should indicate that market players have probably already discounted many of the negatives. When Europe achieves greater clarity about future solutions to its worries, we are likely to see more "normal" conditions, in which fundamental factors can again be decisive, but this may take time. Exactly as before, we will remain cautious towards Equity L/S during the next few quarters. Market Neutral strategies remain higher on our list.

Relative Value

Fixed income strategies generally continued to generate returns during the last quarter of 2011, though to a somewhat lesser extent than in the third quarter. The previously profitable flight to safe government securities lost some ground during the October risk rally, when both the investment grade and high yield markets rose substantially. Liquidity deteriorated somewhat towards year-end, and there was thus a tendency among managers to preferably hold slightly short net positions in the market. This meant they could not fully benefit from the market upturn either.

The macroeconomic risks of a euro zone break-up eased somewhat late in December when the ECB announced liquidity support to banks via (theoretically) unlimited loans at 1 per cent interest. At first this got a fairly cool reception, but market players later seem to have started appreciating the positive impact of these loans in the battle against a systematic euro zone crisis. Successful bond issues in Europe's most vulnerable countries early in January also contribute to our more positive view of fixed income markets. The drama in and around Greece is not over, however, and may naturally have a major impact on the market in the future as well.

Managers must remain tactical and agile, but the investment opportunities are good, especially for high yield corporate bonds, which have not kept up with the broader upturn. There are probably good buying opportunities here and there, both in Europe and elsewhere in the world. On the whole, the environment looks somewhat more balanced, and we are positive towards Relative Value during the next quarter.

Event Driven and Distressed

Event Driven strategies recovered and, after a very troublesome third quarter, made it through the fourth quarter with a positive performance. HFRX Event Driven rose 0.56 per cent during Q4, while HFRX Distressed fell 0.26 per cent during the same period.

Spreads that narrowed as mergers and acquisitions approached their closing dates were a major contribution to the positive trend. M&A activity declined significantly during the second half of 2011 yet was somewhat higher than in 2010. Activist funds benefited from the somewhat improved market climate, but volatility and continued economic uncertainty forced them to maintain strict risk controls. Distressed strategies had a mixed quarter in terms of performance. October was a positive month. When political leaders seemed to realise the severity of the debt crisis, prices of risk assets surged. Managers had hedged large portions of their holdings, which coped relatively well with the turbulence, but another consequence was that long holdings did not keep up as well during the upturn phase. December was a significantly calmer month, but with large differences between managers.

There is an expectation of higher consolidation activity in some sectors, and also an expectation that certain cash-heavy market players will try to make strategic acquisitions. Such an environment is normally positive for Event Driven strategies, but they are meanwhile highly dependent on the financial market's overall state of health. Difficult periods have forced managers to reduce their leveraging and cut back their positions. We still believe that there is good future potential in these segments, but that it is somewhat too early to increase exposure.

Macro and Trading

The final quarter of 2011 saw a continuation of the same spirit as the third quarter, that is, with major differences between various managers. In many cases, the respective manager's view of Europe was crucial to performance. The "risk off" themes that worked well during the third quarter were favoured again in November. After a turbulent year, it was natural to cut back positions towards year-end, which resulted in rather modest movements during December.

Viewed as a group, CTA and Systematic Macro ended the year negatively. In these strategies, as earlier there were major differences between individual managers, depending on model types and asset allocation. Trend-following models in fixed income were the best performers, and managers with a large share of their total allocation in fixed income did nicely. Those with more exposure to fundamental models, as well as those with active trading in commodities, reported negative results during 2011. Currency strategies had a complicated year due to currency interventions by the Swiss and Japanese central banks, which continued in the fourth quarter as well.

Managers still see Europe as the most important area to watch in the near future. Although the liquidity situation has improved, with the help of the ECB's unlimited three year loans, the fact remains that there are extremely large government loans that will fall due and will need to be refinanced in the first quarter of 2012. The turmoil surrounding Greece and continued geopolitical tensions in the Middle East should create interesting opportunities for managers, but they will need the same ability to act quickly as before in order to be successful.

In the last issue of *Investment Outlook*, we highlighted how CTA and Systematic Macro serve as tools for portfolio diversification. These strategies are expected to perform well when other asset classes are having difficulty. This is also true during 2012. Managers have increased their exposures to trend-following models, which have led to large holdings of fixed income securities. Combined with their negative positions in the euro, this gives these funds rather defensive characteristics that diversify "normal" portfolios exposed to more conventional asset classes. Macro and Trading remain our first choices among hedge fund strategies in the near future.

STRATEGY	INDEX	PERFORMANCE % (USD)			
		Jan 2012	Q4 2011	2011	2010
Global Hedge	HFRX Global Hedge Fund	1.72	-0.48	-8.87	5.19
Equity Hedge	HFRX Equity Hedge	2.07	-0.85	-19.08	8.92
Relative Value	HFRX Relative Value Arbitrage	1.72	0.10	-4.00	7.65
Event Driven	HFRX Event Driven	2.80	0.56	-4.90	1.98
Macro	HFRX Macro	0.09	-1.96	-4.88	-1.73

Real estate market is still resilient

- *Greater international interest in European properties*
- *Strained valuations in many primary markets...*
- *...create attractive opportunities elsewhere*

In a normal investment climate it is natural, when analysing various assets, to study potential returns on the basis of economic fundamentals. In a more stressed investment climate, like the one we have been in since summer 2011, the main focus instead ends up being on whether investors should take a risk or abstain from it. In such a climate, it is thus natural that the correlation between different risk assets becomes stronger, which in turn make it more difficult for investors to effectively take advantage of the diversification qualities of different asset classes.

Stable trend for direct property investors

When the stock market fell during the autumn of 2011, the commodities market and private equity companies also performed weakly. Valuations for indirect real estate investments, via listed property companies and real estate investment trusts (REITs), changed in line with the global stock market. One market that suffered considerably less from the reversals that were so common in 2011 was the global market for direct property investments.

The real estate market was not entirely untouched by the year's turbulence, and the negative financial climate reached this market in the third quarter. Because of a flight to quality, demand in primary markets and especially for "trophy" properties benefited at the expense of riskier secondary markets. Real estate deals took longer to close, which was reflected in somewhat lower activity. This, in turn, led to lower expectations for the fourth quarter.

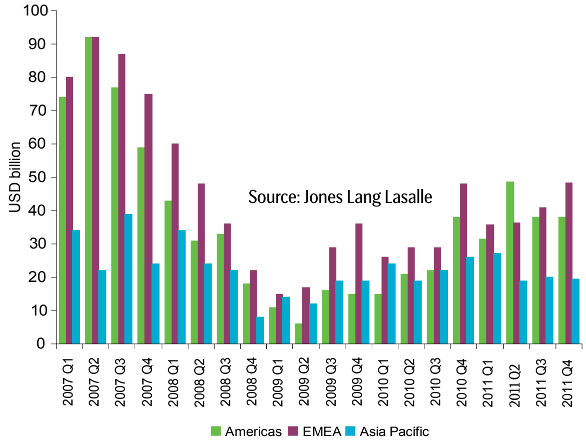
Growing global interest in European properties

Data indicate that the fourth quarter of 2011 turned out considerably better than expected. Surprisingly, the biggest increase in activity was in the commercial property market in Europe, where transaction volume rose rapidly due to greater international interest in the region. This interest focused primarily on German, French, Nordic and Eastern European properties, while foreign investors' interest in southern European properties fell.

In Asia, the volume of commercial property transactions fell further during the fourth quarter of 2011. This decline in activity was offset, however, by increased sales of land, which today account for about 75 per cent of the total market in the region. Although total activity fell constantly during 2011, the fact remains that from a historical perspective the region continues to have a very high activity level.

Activity in the US real estate market fell after last summer, but strengthened during the final months of 2011. In the commercial market, activity was unchanged, while residential sales were among those that strengthened. Looking at 2011 as a whole, the US market performed best overall from an activity standpoint.

BETTER THAN EXPECTED ACTIVITY DURING Q4 2011



The largest increase in activity in the direct commercial real estate market occurred in Europe (part of EMEA), where transaction volume rose rapidly due to increased international interest in the less crisis-hit countries in the region. However, activity in southern Europe is weighed down by the overhanging debt crisis in the region.

Stable yield levels in most places

Geographically, yield requirements remained at largely unchanged levels in all markets, except for peripheral countries in Europe, where they rose. Market players have raised their yield requirements in crisis-hit European countries as a consequence of the mounting risk in the region. On the whole, however, the stable movement in yield levels reflects a relatively resilient real estate market in the turbulent market climate we experienced during the second half of 2011.

For some time, we have also seen divergent trends in different market segments. While yield requirements in primary markets and for "trophy" properties have fallen significantly, yield requirements in riskier secondary markets have risen. Late in the third quarter of 2011, however, there were signs of a shift away from the low-risk segment to somewhat higher risk-taking – a tendency that was also apparent during the fourth quarter.

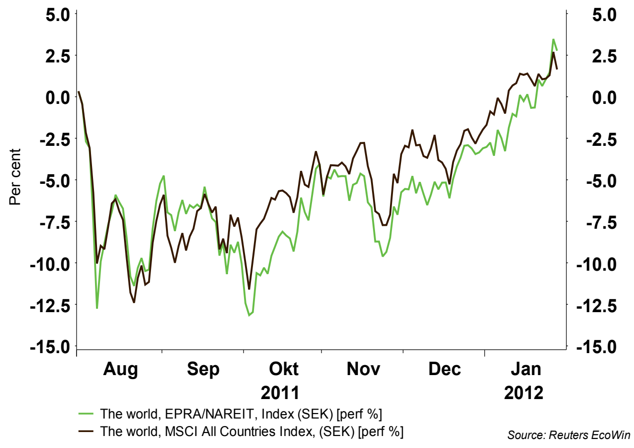
Yield levels have generally been in a falling trend (due to rising prices of existing properties) since the spring of 2009, after having peaked in the wake of the financial crisis. Compared to the levels prevailing before the crisis broke out in 2008, there is further room for recovery, although the risky market we are now experiencing makes it difficult to justify a decline to those levels. The market climate must first stabilise, which means that we will need to see a continued strengthening of the macroeconomic climate (such as we have seen in the US during recent months). European political leaders must find a solution to the prevailing debt problems, reach agreement and – not least – persuade market players to believe in it before we can revert to a more orderly, less risky climate. When, or rather if this occurs, the yield requirements in the real estate market may continue their journey towards 2007 levels.

Indirect real estate investments behave like equities

If direct real estate investments have shown relatively stable performance during the past six months, the picture has been totally different for the indirect real estate market (via real estate company shares and REITs). Since August 2011, the REIT market has nearly copied the performance of the stock market. Its movements during the past six months have been so similar that the daily correlation with the world stock market (MSCI All Country World Index in local currencies) has actually amounted to 95 per cent. In other words, on a daily basis the REIT market has moved in the same direction as the stock market in 95 out of 100 cases. During this period, returns have also been identical, up about 2.5 per cent. From a portfolio standpoint, this is anything but a desirable phenomenon, since the opportunity to take advantage of the diversification qualities of different assets is more or less eliminated. Obviously there are various reasons why the direct and the indirect real estate markets are performing so differently, but one of the decisive factors is the liquidity aspect of various types of investments.

Somewhat more optimistic towards real estate

Since last summer, we have more or less stood on the sidelines of the real estate market. As the general market climate has improved in recent months, transparency has also become somewhat better. Although the picture is not entirely clear, at present our assessment is that valuations in many primary markets are relatively strained. As a consequence of this, some attractive investment opportunities are arising elsewhere. We are sticking to our neutral view of real estate market investments but are somewhat more optimistic today than three months ago.



INDIRECT REAL ESTATE INVESTMENTS ARE PERFORMING LIKE EQUITIES

Since August 2011, the REIT market has nearly copied the performance of the stock market. From a portfolio standpoint, this is anything but a desirable phenomenon, since the opportunity to take advantage of the diversification qualities of different assets is more or less eliminated.

Attractive purchase option on stabilisation

- *Continued financial instability is causing listed PE company market prices to move in tandem with bank shares...*
- *...even though PE companies have stronger finances, lower gearing and more stable profits than before the crisis...*
- *...which, together with low valuations (large discounts), indicates significant potential ahead*

In recent months we have seen a stabilisation in the world's financial markets and good performance for riskier asset classes. At first glance, listed private equity (PE) companies are no exception – they have climbed about as much as the broad stock market since bottoming out in early October 2011. Notably, however, they fell significantly further than the stock market in the preceding downturn phase. As earlier, the market price performance of PE companies is showing great similarity to the financial sector, dominated by banks. Valuations remain at crisis levels, with a discount to net asset value (NAV) of 40-45 per cent for listed PE companies. In a more positive market scenario, private equity will thus be among the probable winners.

In our opinion, today's valuations of PE companies seem rather cautious. The last time we were in the vicinity of current levels – in the spring of 2009 – the world economy was in a very deep recession while highly leveraged PE companies, with their large portfolios of companies bought at peak valuations in the preceding years, suffered severely.

Today, in our view, the situation is different, but claiming that the market is wrong requires assuming the burden of proof. And indeed, there are arguments in favour of why PE companies should be traded with larger discounts than usual. Among these are:

- The risk of a new deep recession
- The risk of a financial meltdown
- Lower return due to lower growth
- Lower return on equity given lower leveraging
- Disappointed investors leaving the asset class (flight from risk)

Let us closely examine these arguments, and their relevance: **A new deep recession** would obviously hurt the holdings of PE companies. In a scenario of declining NAV, the value of portfolio companies falls quickly, while lower growth justifies lower profit multiples – NAV will fall quickly in such a scenario. But this scenario is far from our main scenario. It is also important to note that portfolio companies are generally in better shape than during the 2008-2009 crash, when many of them had been bought during a raging economic boom – these companies have received a fair amount of work since then.

A financial meltdown, for example one triggered by a euro collapse, cannot be ruled out. In the short term, this would deal a heavy blow to the PE sector – especially to sentiment, via reduced risk appetite. Unlike the last financial crisis, however, the sector's financial stability is good today. The degree of leveraging is generally lower and the duration of debts significantly longer, with a good distribution of maturities. Over the next few years, only a small fraction of these companies' debts fall due. Their overall financial strength is so good that these companies can withstand a relatively long period of financial stress, but a lengthy crash would probably also have a major impact on global growth. In such a scenario, PE would naturally be affected, but not necessarily more than other sectors. However, we would probably see a significantly tougher financing situation ahead, given global financial problems. More difficult and/or more expensive financing solutions should reasonably justify a higher discount to NAV, all else being equal – but on the other hand, the low interest rates that would probably be part of this scenario would make the financial costs manageable.

Most observers expect that **growth will be low** for several years into the future. This naturally decreases the potential for large profit increases in portfolio companies and also justifies less aggressive valuations. But in relative terms, compared to the broad stock market, PE companies should instead benefit from this. As long as there is growth, an active ownership agenda, combined with higher leveraging when borrowing, would be capable of generating better profit growth.

The fact that PE companies today are less highly leveraged than during the peak years before the Lehman Brothers crash naturally means that potential **return on equity will be lower.** This may justify somewhat lower valuations. On the other hand, it implies increased financial stability and lower risk, which at least partly offsets this effect.

Finally, the risk that investors **will completely abandon this asset class** must now be deemed relatively small. Some market players, such as European banks, are in the process of winding down their PE positions, but many already left private equity after the previous crash, and from 2010 until last autumn new PE funds noted good inflows.

Taken together, there are thus arguments in favour of lower valuations and higher discounts than the historical average. But discounts to NAV averaging 40-45 per cent – including many stable companies with good credentials priced at half their net asset value – are exaggerated. We believe that current valuations indicate a crashed market, and we are not there yet. The sector is in significantly better shape than before the previous crisis. The main arguments in favour of the situation being better than valuations indicate are:

- A significantly lower proportion of portfolio companies bought at the peak (2006-2008)
- Generally higher operating margins
- Higher financial resilience via longer debt maturities
- Lower debt

We believe that the market does not fully appreciate the changes that have occurred in this sector since the previous crash and is thus wrongly "lumping together PE companies with financials" in their valuations. The crucial differences are that PE companies today, unlike banks, are not directly impacted by financial crises, large debt write-downs etc. At the same time, they have much greater opportunities to generate added value in their asset holdings via active ownership.

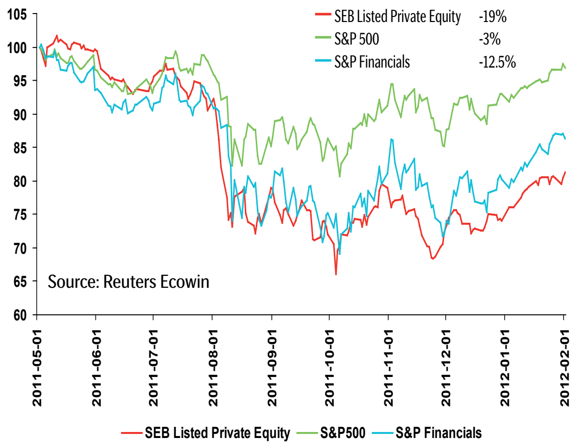
One illustration of this occasionally stingy attitude towards PE companies is that in the second half of 2011, Apax Partners, a major European PE company, divested 25 per cent of its portfolio of companies at prices about 30 per cent higher than reported NAV. Meanwhile the discount to reported NAV (not including the divested companies) increased from 48 to 52 per cent. Since the nature and quality of the remaining portfolio companies is considered the same as those of the divested companies, today's valuation seems little short of remarkable.

These low valuations also imply a floor, since they open the way to various types of value-generating transactions. Last autumn another large PE company, SVG Capital, announced a programme to repurchase its own shares. At the time, its discount to NAV was 48 per cent. After these transactions, the company was traded at a discount of 28 per cent and the share price had climbed 30 per cent.

In the market for secondaries (existing PE investments in the secondary market), the discounts are generally smaller. This creates opportunities for listed PE companies. For example, they can sell investments in the secondaries market at a higher valuation than applies to the listed company, which boosts its value. The lower discount for secondaries is also a reason why we prefer listed companies.

Today's situation is challenging for PE companies. At present, their outlook is hampered by doubts about the strength of economic growth, coupled with a severely handicapped financial market, practically non-existent potential to sell off companies via the stock market and the likelihood of a tougher financing climate ahead. As long as that situation lasts, prices of PE companies are unlikely to surge. But if we should see a combination of clear stabilisation in overall conditions with reasonable economic growth – and with increasing risk appetite leading to revaluations of PE companies back to their historical average levels – the upside potential is significant. And even in a cautiously optimistic scenario, such as our main scenario, private equity has the muscle to be among the winners. The sector offers an attractively valued purchase option on future growth.

UNJUSTIFIABLY WEAK PERFORMANCE



During last autumn's stock market reversal, private equity companies fell more than the stock market as a whole, which in itself is not unreasonable. However, the slide was as large as for the financial sector generally, which seems to be an overreaction since PE companies are not as clearly affected by financial problems. It is also worth noting that PE companies have risen less than the Financials index (but more than the broad index) during the recovery of recent months.

Continued price decline for agricultural commodities

- *Oil prices will remain at high levels*
- *Chinese soft landing will benefit industrial metals*
- *Normal weather means cheaper agricultural commodities*

As risk appetite has returned, and as many of the world's stock markets have begun 2012 with sharply rising share prices, commodity markets have also performed strongly. Industrial metals, the most cyclically dependent commodities, stand out with double-digit percentage upturns in many cases, but we have also seen price gains for precious metals and some agricultural commodities. Oil prices (Brent crude), which withstood last year's turbulence remarkably well, have nevertheless not moved significantly during early 2012.

Developments in Iran may ignite oil prices

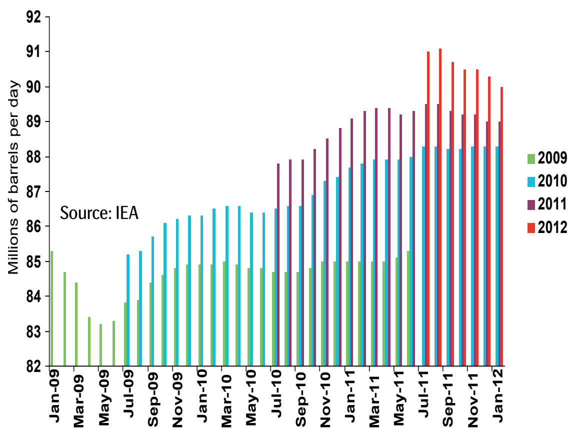
There are arguments in favour of both rising and falling oil prices during the coming year. Demand growth is uncertain in light of the macroeconomic environment we are in. Meanwhile oil production is rising in such countries as Libya, Iraq, the US, Canada and Brazil. Increased supply and sagging demand would push down oil prices. But it is worth noting that despite the recent downward adjustments in forecasted demand in 2012, these forecasts are still well above 2011 demand (see the IEA forecast in the chart). The risk of supply disruptions has also increased – especially as a consequence of the problems surrounding Iran's alleged development of nuclear weapons, but also the ongoing conflict in Nigeria and general uncertainty in the Middle East and North Africa (MENA) region. In addition, global oil stocks are low (European reserves are now at levels we have not seen since 2003). In the event of a supply disruption, the risk of sharp oil price increases is obvious.

Assuming there are no extraordinary events, which might cause supply to fall rapidly, we believe that OPEC (Saudi Arabia) will gradually adjust supply to reduced demand in order to keep oil prices above USD 100 per barrel (since this is the level that Saudi Arabia needs in order to achieve a balanced government budget). If demand falls at a modest pace, this will therefore probably not lead to dramatically falling oil prices.

Iran represents the big upside risk for oil prices. It is continuing to develop the capability to build nuclear weapons, while the US and Europe are introducing sanctions to persuade Iran to change its mind. Unfortunately Iran is geographically well placed to create havoc if the country finds enough reasons. This is because Iran controls the Strait of Hormuz, through which 35 per cent of all seaborne oil cargo passes and might (at least theoretically) close it, with sharply rising oil prices as a consequence. In practice, such a step would probably lead to armed conflict, but credible threats to close the Strait would probably be enough to drive oil prices to new record levels.

Provided that no exceptional events occur, we believe that during 2012 oil prices will remain high – at around today's USD 110 per barrel, and perhaps somewhat higher.

GLOBAL OIL DEMAND IS CLIMBING EVERY YEAR



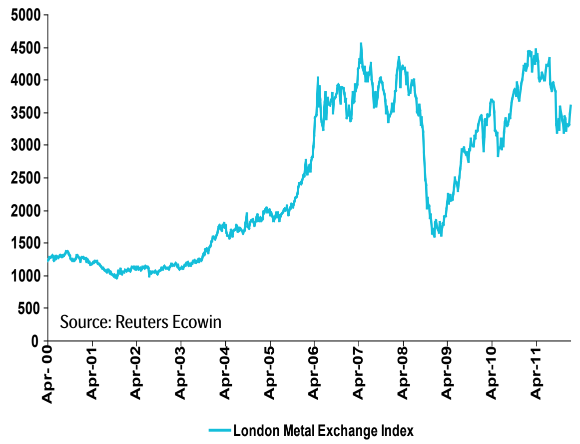
As the above International Energy Agency (IEA) forecast of oil demand indicates, 2012 demand will exceed 2011 demand by about a million barrels per day despite recent downward adjustments.

Chinese soft landing will drive metal prices

Will industrial metal prices rise or fall during 2012? In many respects, this is the same thing as asking whether the Chinese economy is facing a soft or a hard landing. This is because China accounts for 40 per cent of the world's industrial metal consumption. Our main scenario is that China will experience a soft landing, and if we are right there is potential for rising industrial metal prices. There have also been recent signals that reinforce our perception that there will be a soft landing. Inflation in China has fallen sharply, while GDP growth has stabilised at a high level. Industrial activity has also stabilised, and China has taken its first step – in the form of reduced reserve requirements for banks – towards loosening its monetary policy. Falling home prices in China are still a source of concern that may disrupt this picture from time to time.

Since overall metal prices, as expressed by the LME Index (see chart), have fallen by about 25 per cent since their 2011 peak, a cautious future scenario is already reflected in today's prices. Furthermore, at present a number of industrial metals are being traded at their marginal product cost and the risk of sharply falling prices seems limited.

VOLATILE METAL PRICES OVER THE PAST FIVE YEARS



After large price upturns for metals during 2009 and 2010, prices fell sharply during the second half of 2011 but now seem to have stabilised.

For zinc, higher supply than demand has led to rising stocks and falling prices, making it the metal with the least potential for price increases ahead.

Driven by a highly strained supply and demand situation, we believe that copper has the largest potential for price upturns. Unlike various other metals, however, copper is traded at well above marginal production cost, which consequently means that it will probably be affected the most both by positive and negative surprises.

Gold is not always a safe haven

Prices of precious metals fell during the second half of 2011, among other things because the US dollar gradually gained strength. In troubled times, gold has historically been a refuge for investors, but late in 2011 a stronger dollar, smaller speculative gold positions and accelerated liquidity measures weighed more heavily than the protection that gold is regarded as offering in times of great uncertainty. As a consequence, gold prices fell even though market worries increased. Early in 2012, gold prices rose a bit. We believe that there is support for somewhat higher gold prices during the year. Exceptionally low interest rates for a long time to come, reduced inflation risk and potential further monetary stimulation measures support this forecast.

Decades of rising gold prices have created incentives for increased production. In the past 4-5 years, gold ore production has increased to the same extent as gold prices. This is a worrisome signal, since gold prices have historically risen only when the supply had fallen or stagnated.

We have a cautiously optimistic view of precious metals during the rest of 2012. We prefer gold to silver, due to lower volatility. Both palladium and platinum are attractive, but they both represent small markets.

Falling agricultural commodity prices ahead

Since early summer 2011 most agricultural commodities have shown a falling price trend, and we expect this to continue. Drought in South America due to the La Niña weather phenomenon temporarily propped up prices late in 2011 and early in 2012, but after several years of exceptional weather conditions we expect the situation to normalise this spring. This supports our forecast of better harvests and lower prices.

One commodity that has potential to go against this trend is cotton. The driving forces behind this are lower stocks combined with strong competition for agricultural land, and the fact that demand has not yet recovered since 2008.

The economy will drive commodity prices

During 2012 there will be continued improvement in macroeconomic statistics from the US, looser monetary policy in China and long-term measures from the European Central Bank (ECB), which will drive commodity prices upward. Economic data from the US has recently exceeded expectations in many cases, and the continued decline in Chinese inflation opens the way for a less contractive monetary policy. A first step in this direction occurred in December when China lowered the reserve requirements for banks. We will probably see further steps in this direction, which will provide support for commodity prices. The ECB's decisiveness will also give the market reasons to be more optimistic about the future.

Demand for quality in the FX market

- *Further weakening of the euro is likely ahead*
- *Financially strong currencies/countries will be favoured*
- *The revaluation of the Chinese yuan will continue*

The collective risk appetite of investors tends to determine what driving force will predominate in the foreign exchange (FX) market. During periods when investors are fleeing risk, the liquidity of currencies is by far the most important factor. Such a climate prevailed during much of last autumn, favouring major currencies with "safe haven" status such as the US dollar (USD), the Japanese yen (JPY) and the Swiss franc (CHF).

Recently, however, more positive sentiment has crept into the market, sustained by surprisingly strong macroeconomic statistics from the US and a lack of negative surprises from the euro zone. The biggest contributor to the increased risk appetite, however, was a decision by the European Central Bank (ECB) in December to essentially flood the European banking sector with liquidity. As investors have dared to leave their safe havens, there has been increased demand for currencies of countries that show fundamental strength, for example in terms of GDP growth, government debt and current account balance. Currencies that fit this description include the Swedish krona, the Norwegian krone, commodity-related currencies like the Canadian dollar (CAD) and Australian dollar (AUD) as well as numerous emerging market (EM) currencies.

Fundamentals will set the pace

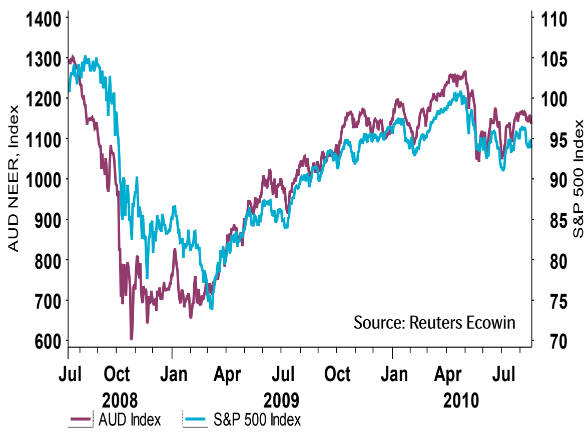
The world economy is still in a wait-and-see mode, and the financial crisis in Europe is having a clear impact on the real economy. Today a long-term solution to the euro zone crisis seems distant, and political leaders are not likely to surprise the world with resolute action. But although the process is of the two-steps-forward-and-one-step back type, European political leaders are moving in the right direction and taking gradual steps towards deeper collaboration.

There is no miracle cure for sick euro zone member countries, but at the moment the acute phase is over. This will give investors breathing space and time to lift their gaze and consider the potential for global economic growth.

The investment climate is somewhat better. Aside from China's apparent avoidance of a hard landing and the potential for the US economy to grow at a decent pace, a clear change of attitude is evident among most central banks. They have shifted their strategies and have now generally embraced expansionary monetary policies, thereby fuelling risk appetite.

In the investment climate that we foresee, currencies backed by strong government finances and current account surpluses should thus continue to be in demand. However, we see risks of temporary corrections, since developments in the euro zone crisis will also likely remain unpredictable. This may hurt such currencies as the Norwegian krone, the Swedish krona and the Australian dollar, since they have appreciated sharply in a short period and are sensitive to fluctuations in risk appetite.

AUSTRALIAN DOLLAR TRACKS THE STOCK MARKET



In the FX market there are various currencies that are cyclical and move in tandem with the stock market. The Australian dollar is the clearest example, but the Swedish krona and the South Korean won are also affected by shifting market risk appetite.

General euro weakness ahead

The most heavily traded currency pair in the FX market is the euro against the US dollar, and the movements of the EUR/USD exchange rate generally reflect world stock market trends. When market risk appetite decreases, the stock market falls and investors tend to buy dollars, causing the EUR/USD rate to fall. Since December 2011, however, this pattern has been interrupted and the euro has lost ground against the dollar at the same time as the stock market has moved upward. One explanation is that risk appetite is no longer so closely connected to the events unfolding in the euro zone. Because of the gloomy outlook for southern Europe, the euro is trending lower and lower, while the lack of negative news from the euro zone is enough to keep risk appetite up. It is thus a matter of a general weakening of the euro, not investor flight to the liquid US dollar.

The euro has weakened significantly in recent months, and although this weakening now seems to have paused, the downward trend is likely to continue. A sustainable long-term solution for the euro zone's problems is distant, and the economies of some southern European countries are teetering on the brink. SEB's forecast is that the EUR/USD exchange rate will stand at 1.22 by summer 2012 (at present about 1.32). We expect the euro to move downward towards 8.50 against the Swedish krona (current rate 8.80).

The dollar benefits during periods of intensified worries about the EUR, but the USD has also appreciated on its own merits. Activity in the US economy has been unexpectedly high, with positive signals from both the American labour and housing markets. While the US economy accelerates, the Nordic economies will decelerate during 2012. This is why we expect the USD/SEK exchange rate to appreciate during the second quarter to about 7.00 per Swedish krona (today about 6.70) and the USD/NOK rate to appreciate to 6.15 (today about 5.75).

Mixed picture for EM currencies

Due to their many connections to the euro zone, the outlook for Eastern (including Central) European currencies does not look so bright. Some countries in the region also have fundamental weaknesses. Hungary has a large public sector debt, banks in Romania have close ties to Greece and Turkey, and current account deficits are being noted in Poland. In contrast, the outlook for Latin American currencies is significantly brighter. National finances are generally stronger, and meanwhile we predict that prices of precious and industrial metals will climb during the coming year.

We foresee that Asian currencies have the best outlook. In many cases, Asian economic fundamentals are extremely strong, with rapid growth, enormous current account surpluses and low central government debt. High bond yields compared to the OECD countries may also attract foreign capital and help drive the future exchange rates of Asian currencies.

Stronger Asian currencies can also be justified politically. Asia, led by China, would like to increase domestic consumption and become less export-dependent. Meanwhile indebted households in the West need to reduce their consumption and Western countries instead need to boost their exports. One tool for remedying today's prevailing imbalances is stronger Asian currencies, which will make imports cheaper in local terms and benefit Western exporters.

For more than a year, the Chinese authorities have allowed a gradual strengthening of the yuan (CNY). This appreciation will continue, but the pace of revaluation is likely to be slower than previously. The reason is that the slowdown in global demand is pulling down Chinese export growth and that inflation pressure in China has eased in recent months. We expect the USD/CNY exchange rate to stand at 6.00 in December 2012 (the CNY is trading around 6.30 today).

YUAN REVALUATION WILL CONTINUE

The Chinese authorities have gradually revalued the yuan (CNY) against the USD. The pace of yuan appreciation has slowed somewhat due to lower inflation, flagging export growth and a generally stronger dollar. We foresee a USD/CNY exchange rate of around 6.00 at the end of 2012. The chart also shows China's mirror currency, the CNH, which foreign investors can buy.

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SEB Private Banking has some 370 employees working in Sweden, Denmark, Finland and Norway. Outside of the Nordic countries, we take care of our clients via offices in Estonia, Latvia, Lithuania, Switzerland, Luxembourg and Singapore as well as a branch in London. On December 31, 2011, our managed assets totalled SEK 248 billion.

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