Investment Outlook

May 2012

Searching for safe havens in a turbulent market

PRIVATE BANKING - INVESTMENT STRATEGY

SEB

Contents

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Its contents are based on information available before May 15, 2012.

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A year dominated by politics

There are great tensions among voters because of the austerity programmes now under way around Europe, and the political picture will remain a risk factor for financial markets. The era of generous political programmes is past, and the consequences are painful. Meanwhile the solution to debt problems is economic growth.

We recently heard the election results from France and Greece. Later this year, the focus will be on the United States and the American presidential election. What can political leaders do? As Bill Clinton's campaign advisor James Carville said in 1993: "I used to think if there was reincarnation, I wanted to come back as the president or the pope.... But now I want to come back as the bond market. You can intimidate everyone." Carville's words still ring true, and overly ambitious policies will be difficult to carry out, given today's financing needs. The era of generous political programmes is definitely past, and the consequences are painful.

Meanwhile economic growth is the only way to resolve the debt issue in the long term. The US has repeatedly demonstrated this and may do so once again. Europe, on the other hand, has a longer and more difficult journey ahead. In this issue of *Investment Outlook*, we have dedicated our main Theme article to politics and its impact on financial markets. These are big issues that need to be examined. The debate in Europe on balancing stimulus and belt-tightening is one example. Can austerity agreements be re-negotiated? Is it possible to enact growth-stimulating measures? Yes, it is quite possible. Italy is an example of a country where political programmes may be viewed as promoting growth.

In stock markets, we have what may be perceived as a paradox. Corporate profit margins remain high, despite slow growth and a price squeeze. To some extent, this may be due to the amount of slack in the economy, high unemployment etc., but in reality the picture is much more complex. This topic is interesting and deserves more in-depth analysis. One explanation may be that today's companies are much more flexible in their operations and are thus better optimised. High margins are one of the factors that provide some hope about the stock market, despite relatively limited global growth. In this issue, we have chosen to divide our Equities section into two parts: one that closely examines the Swedish and other Nordic stock markets and one that focuses on the global stock market outside the Nordic region.

Modern investors move between different asset classes today. The world offers more opportunities than before. We capture some of these opportunities in our Modern Investment Programmes, but we cannot fit everything into these portfolios. Forestland investments are one example. Interest in forestland investments is greater than ever. We have looked at the various possibilities that exist and compared the potential returns to other asset classes. Is it worth the risk? Or is this merely a romantic investment that gives you natural scenery you can enjoy spending time in, but whose value you will have to wait a long time to benefit from?

One factor that has worried many financial investors, and which we have touched on in earlier issues, is that very low bond yields make it difficult to invest capital at limited risk but with reasonable returns. But the resourceful will find a solution. Opportunities exist, and in today's investment climate where more and more people want to limit their risks, our Theme article on this topic is important reading.

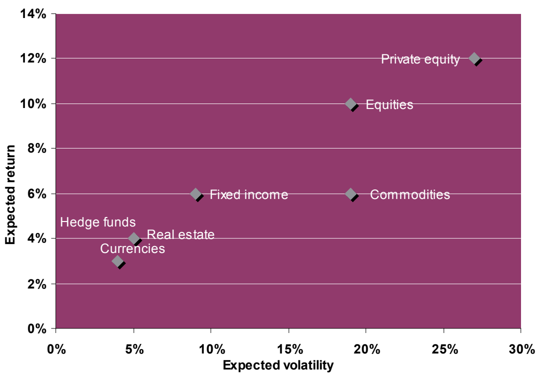
This is not an easy year for investors (as if any year were easy). Stock markets began 2012 strongly and may end the year well, if world economic growth holds up. In spite of everything, we are continuing to find safer returns in corporate bonds. We have completed one and a half quarters of what will be an interesting year: painful and difficult in many places, yet an interesting year.

HANS PETERSON
CIO Private Banking
and Global Head of Investment Strategy

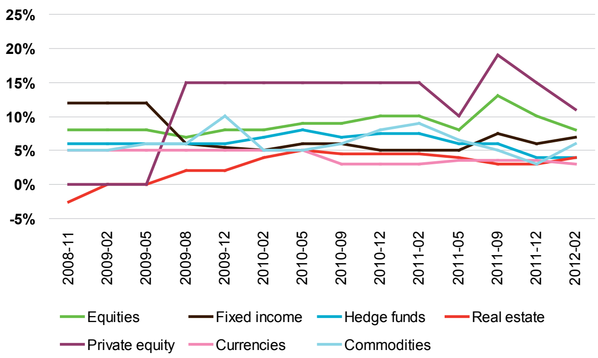
	Expectations* Next 12 months return	risk	Reasoning *Forecasts are taken from the SEB House View and are based on our economic growth scenario (see page 8).
Equities [1]	10%	19%	**NEGATIVE** in the short term – uncertainty about the euro zone debt crisis and wobbly US growth. Positive news already priced in. **POSITIVE** in the long term. Good future conditions for the stock market. Trend towards greater risk appetite in investors' search for returns. Strong balance sheets and valuations below historical averages.
Fixed income [2]	6%	9%	**NEGATIVE** towards government bonds in OECD countries. Central banks will stick to stimulus agendas. Because of low OECD government bond yields, investors are seeking returns elsewhere. **POSITIVE** towards government bonds in emerging markets, where yields remain elevated. Falling inflation in BRIC countries will provide room for bond yields to fall. **POSITIVE** towards corporate bonds, with a focus on high yields bonds, where yield gaps against government bonds indicate that the market is pricing in a significantly higher than probable percentage of bankruptcies.
Hedge funds	4%	5%	**NEUTRAL/POSITIVE.** Strategies with high market exposure have benefited, but a turbulent financing market has created a generally tougher climate. Smaller fluctuations in risk appetite will provide good potential for recovery.
Real estate	4%	5%	**NEUTRAL.** Tighter financing conditions and a continued uncertain economic outlook led to lower transaction activity in early 2012. The co-variation between this asset class and the stock market is diminishing, creating better conditions. The REIT market will be the most interesting when risk appetite returns.
Private equity	12%	27%	**NEUTRAL.** Due to continued macroeconomic and financial risks, PE companies can rely to a lesser extent on fundamental factors such as growth and credit availability. Continued high discounts will provide good potential in the long term, but the ability of managers to generate alpha will be the most important key to success in the near future.
Commodities [3]	6%	19%	**NEUTRAL/POSITIVE.** Aside from agricultural commodities, economic developments – with a focus on China – will determine the price trend for commodities. Assuming there is a soft landing in China and that global growth will progress at a reasonable pace, prices of many commodities – especially industrial metals – have the potential to rise.
Currencies [4]	3%	4%	**NEUTRAL.** Due to worries about the situation in Spain as well the French and Greek election results, the euro will probably trade at a somewhat lower level. A recovery in the US economy plus risk appetite will probably result in a stronger USD, while further quantitative easing by the Fed would have a weakening effect.

[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.

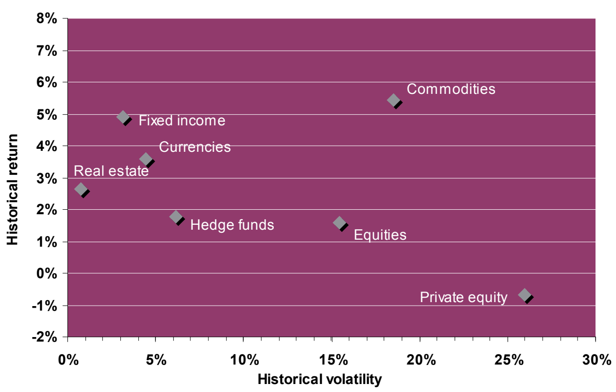
EXPECTED RISK AND RETURN (NEXT 12 MONTHS)



CHANGE IN OUR EXPECTED RETURN



HISTORICAL RISK AND RETURN (MAY 31, 2002 TO APRIL 30, 2012)

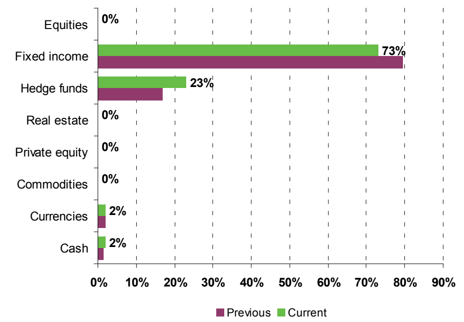


HISTORICAL CORRELATION (MAY 31, 2002 TO APRIL 30, 2012)

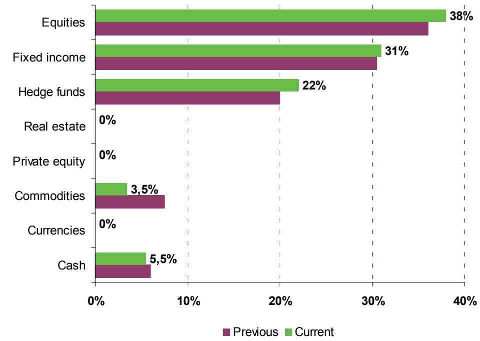
	Equities	Fixed income	Hedge funds	Real estate	Private equity	Commodities	Currencies
Equities	1.00						
Fixed income	-0.46	1.00					
Hedge funds	0.59	-0.30	1.00				
Real estate	-0.12	0.08	-0.05	1.00			
Private equity	0.85	-0.36	0.67	-0.13	1.00		
Commodities	0.24	-0.15	0.67	-0.05	0.38	1.00	
Currencies	-0.18	0.19	0.16	-0.09	-0.05	0.07	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.

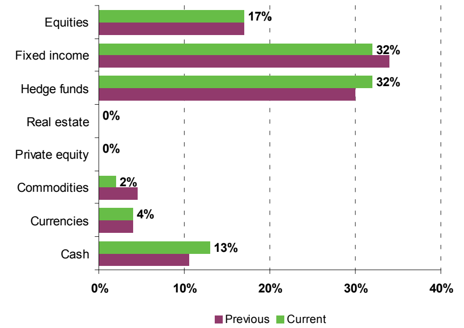
WEIGHTS IN MODERN PROTECTION



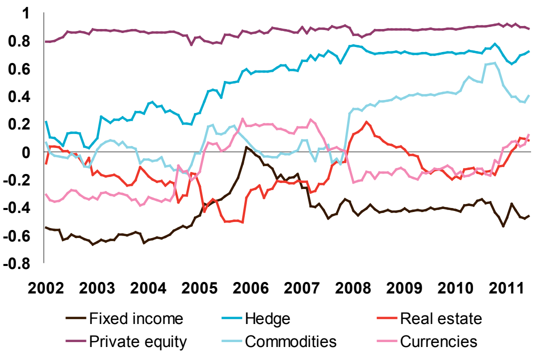
WEIGHTS IN MODERN AGGRESSIVE



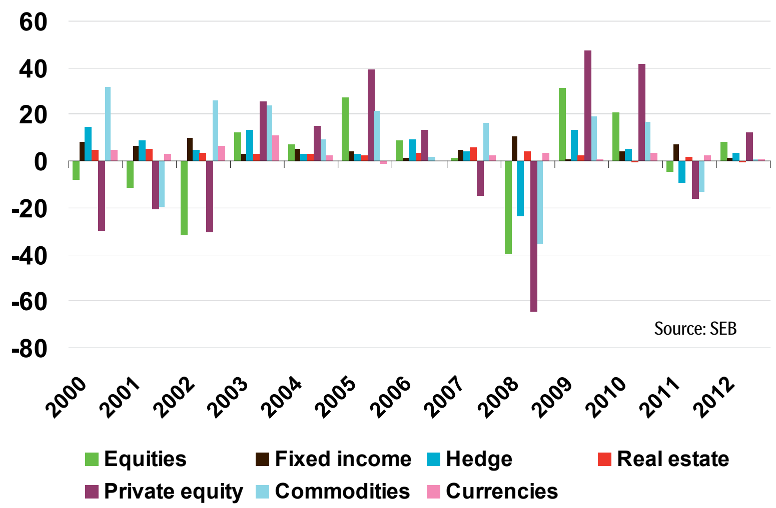
WEIGHTS IN MODERN GROWTH



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



PERFORMANCE OF DIFFERENT ASSET CLASSES SINCE 2000



Return in 2012 is until April 30.
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.

A variable world economic climate

- *A winter of rising risk appetite and optimism...*
- *... has been followed by a spring of renewed worries, focusing on Spain*
- *We still foresee accelerating global growth, but risks have again increased*

When the European Central Bank (ECB) offered its three year loans to euro zone banks this winter, it was the catalyst for a wave of relief – reflected in rising risk appetite and optimism. Since then, however, market worries have returned. The deepening crisis in Spain and the political impasse in Greece have again underscored the serious risks and challenges the euro zone faces, and economic signals from the United States have become more mixed. Meanwhile the emerging market (EM) sphere is carrying out an economic soft landing, while preserving fairly rapid growth. This will help sustain the world economy, but is not enough to lift it. Yet we predict global GDP growth of about 3.5 per cent this year and above 4 per cent in 2013.

To some extent, the risk situation has shifted in a negative direction over the past few months. A deeper sovereign financial crisis in the euro zone remains the most likely potential driving force behind a recession in the 34 industrialised countries of the Organisation for Economic Cooperation and Development (OECD) as a whole. The main source of upside potential is still that the US economy will enter a more normal recovery, with positive contagious effects on the world economy. Meanwhile the prospects of clearly lower inflation will allow room for continued very expansionary monetary policy in OECD countries and pave the way for key interest rate cuts in the EM sphere.

The American economy will chug along

In recent months, US economic performance has been roughly as we expected. Job growth accelerated this past winter, but partly due to historically warm winter weather. GDP growth, not surprisingly, slowed in the first quarter to a bit above 2 per cent from 3 per cent in the fourth quarter of 2011. We predict that GDP will increase by 2.5 per cent this year and a little faster in 2013. Short-term risks include high oil and petrol prices. Later this year, uncertainty may arise due to fiscal policy worries in the run-up to the November 6 presidential election and due to the 2013 budget outlook. Unemployment will level out this year but fall in 2013. Next year, inflation will be significantly lower, and such prospects leave the door ajar for a third round of quantitative easing (QE3) in the form of bond purchases by the Federal Reserve, the US central bank.

New wave of euro zone financial worries

After a period of stabilisation early in 2012, market worries about euro zone government finances escalated again, with a focus on Spain's public finances, the political situation in Greece and a gloomy macroeconomic outlook. There is a growing likelihood that Spain – like Greece, Ireland and Portugal – will be forced to seek a bail-out. The new governments of both Spain and Italy have a clear political focus on reforms and on getting their finances under control. Our main scenario is that Spain will have to seek a bail-out but that the euro zone will stay together. Financial worries have caused the economic outlook in the currency union to fall. We expect overall euro zone GDP to decline by more than 0.5 per cent in 2012 and to grow by less than 1 per cent in 2013. Despite this year's recession and worries about Spain, the ECB has recently remained passive.

Brief British recession

British GDP fell both in the fourth quarter of 2011 and the first quarter of 2012. The United Kingdom has thus dipped into recession, but we predict that it will be brief. While fiscal austerity programmes and a weak labour market are weighing down the economy, several leading indicators have climbed significantly since last autumn. We forecast GDP growth of 0.5 per cent this year and more than 1.5 per cent in 2013. British inflation will exceed the Bank of England's 2 per cent target this year, but will fall below it next year. The BoE has shelved further quantitative easing (bond purchasing) plans, and its key interest rate looks set to remain at 0.5 per cent at least until early 2014.

Nordics are affected but will cope nicely

Weaker international demand is hampering growth in the export-dependent Nordic economies. In 2012, GDP growth will be only about 0.5 per cent in Denmark, Finland and Sweden, but Norway – which has strong domestic demand – will show faster growth this year than in 2011. Fairly good central government finances and current account surpluses have given the Nordic countries manoeuvring room during the period of economic crisis elsewhere in Europe.

Japanese recovery is on track

Japan's economic recovery is continuing, thanks to reconstruction following last year's natural disasters and an expansionary fiscal policy. We predict GDP growth exceeding 2 per cent in 2012 and more than 1.5 per cent in 2013. But there are sources of concern, mainly in the form of problems with energy supply and expensive oil. Due to large idle capacity in the economy, deflation – a general decline in prices – will persist for the fourth straight year, thus probably making 2012 another year of falling consumer prices. Together with an undesirably strong currency, this is an argument for a continued zero interest rate policy for a long time to come, along with additional bond purchases by the Bank of Japan.

Emerging Asia tops global growth

Asia excluding Japan will again be the world's fastest-growing region in 2012. Most Asian economies accelerated a bit early in 2012, and we predict that faster growth will prevail during the second half of this year and in 2013.

China's GDP grew by more than 8 per cent in the first quarter, a noticeable deceleration from 2011, but there are signs that economic growth bottomed out in early 2012. We predict GDP growth of 8.5 per cent in 2012 and a bit above 8.5 per cent in 2013. Inflation has cooled considerably since topping out last summer. We expect the central bank to keep lowering its reserve requirements for banks, and we foresee a Chinese key interest rate cut during the third quarter of 2012. We believe that the economic slump in India bottomed out in the final quarter of 2011, when GDP growth slowed to just above 6 per cent. We expect GDP to grow by 7.0 per cent in 2012 and 7.5 per cent next year. India's inflation rate has fallen slightly but is likely to rise again in 2013. This leaves only limited room for further key interest rate cuts.

Favourable macro figures in Latin America

Last year overall GDP in Latin America grew by more than 4.5 per cent. This year a deceleration is likely for the region as a whole, while Brazil – its largest country – looks set to speed up a bit compared to last year. We believe faster growth will dominate 2013 on a broad front and foresee GDP growth in Latin America of about 4.5 per cent. Inflation in the region will fade somewhat this year but remain persistently high. Among Latin America's favourable macroeconomic figures are strong trade balances, small budget deficits and public debt averaging less than 35 per cent of GDP.

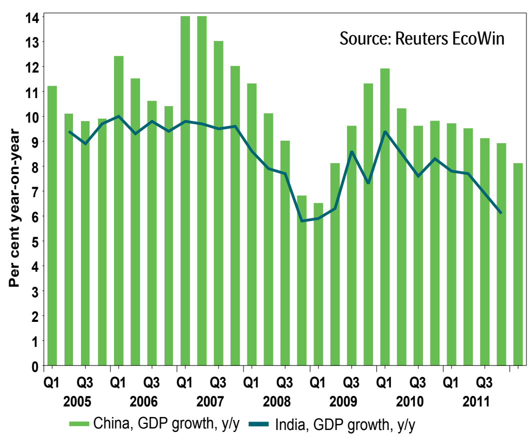
Eastern Europe will grow – at different rates

Eastern (and Central) European economies will grow at different rates in 2012-2013 due to varying export-dependence and differing degrees of financial and trade links to the euro zone. The northern parts of the region including Russia and Poland will cope with the euro crisis relatively well, while some central and especially southern parts will be harder hit. The Baltics and the Czech Republic will be among the "medium hard hit", while Bulgaria, Croatia, Romania, Hungary and Ukraine will be the "hardest hit", due to relatively strong euro zone banking ties.

During 2011 the three Baltic countries had the highest economic growth in the European Union, but late in the year these economies began a deceleration that was completely tied to the international cyclical downturn, especially in Western Europe. Exports will remain relatively weak during the coming year, while consumption will grow at a decent pace. Harsh austerity policies are past, though Latvia and Lithuania will continue public budget-tightening this year. We predict Baltic GDP increases of 1.5-3.0 per cent this year, and a little faster in 2013.

A changing world economic climate

After last year's GDP growth of 4 per cent (measured as purchasing power parities), we expect a deceleration to just above 3.5 per cent this year, while our forecast figures for 2013 indicate an acceleration to more than 4 per cent. The EM sphere will continue to grow substantially faster than the OECD countries, or by nearly 6 per cent compared to about 2 per cent. We have revised our forecasts for the world economy marginally upward compared to our February 2011 estimates.



RATHER SMOOTH ECONOMIC DECELERATION IN CHINA AND INDIA

After a shallow dip in GDP growth during 2008/2009, the rate accelerated in China and India, then gradually slowed from mid-2010 (Q1 2012 statistics for India are not yet available). Judging from recent indicators, growth rates in the two economies are now approaching their lows. Our forecast is that growth will successively speed up starting this summer.

Getting ready for a new dose of turbulence

Risk in various shapes is back in investors' vocabularies. Political events in Europe and elsewhere are not helping sustain markets. A more reserved attitude towards risk is clearly justified. Since April we have reduced the cyclical sensitivity of Modern Growth and Modern Aggressive. In Modern Protection, we have decreased those positions that are most dependent on investors' risk appetite.

MODERN PROTECTION

At this writing, the yield on 10-year US Treasury notes was 1.84 per cent, marginally lower than at year-end 2011 (1.87), but this comparison does not show that yield rose to 2.37 per cent in March, then fell again. This movement coincided with generally stronger American macroeconomic statistics in the early months of 2012 – boosting hopes of a better American economic scenario, only to fall short of analysts' estimates since early April. After some brief swings, German long-term sovereign yields have fallen to 1.52 per cent. Globally, government bond yields have climbed nearly 1 percentage point since year-end 2011, according to the JP Morgan Global Government Bond Index measured in euros.

Since the turn of the year, economic forecasters have gradually adjusted their GDP estimates upward. We predict that macroeconomic data cannot provide the market with as many upside surprises as before. After a strong first quarter for risk assets in general, we thus see a greater risk that the market will be more influenced by negative news. For example, euro zone worries have returned to the spotlight, this time with Spain in the starring role. In addition, more and more market players fear a hard landing in the Chinese economy – which would strike a blow to the global recovery.

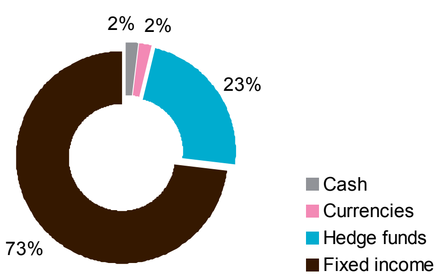
For a low-risk portfolio like Modern Protection, it is becoming increasingly important to look for flows of returns that are independent of economic trends and investor risk appetite. In April we thus reduced our exposure to high yield corporate bonds to 2.6 per cent from 4.6 per cent. Although the underlying arguments are the same – strong company balance sheets, attractive yield differentials to sovereign bonds and default rates (the number of credit events such as bankruptcies and restructurings) below historical averages – this asset class is also sensitive to investors' collective willingness to bear risks.

A scenario of declining risk appetite also adversely affects emerging market bonds issued in local currencies. Although their high yields remain attractive, in a shaky market capital will seek out "safe" currencies like the US dollar, weakening EM currencies as a consequence. We have thus sold our 2 per cent holding in EM debt.

Otherwise we are keeping our fixed income sub-portfolio positions: 25 per cent in short-term bond funds, and 35 per cent in free mandates with potential to generate returns regardless of the direction of the fixed income market. About 6 per cent is invested in leveraged loans, which can be described as high yield bonds, but with loan collateral in the companies' assets and floating rates.

In the hedge fund sub-portfolio, we have increased our allocation to the Credit Long/Short strategy to 4.5 per cent, a strategy that tends to perform well when the credit market is tough. This position should be viewed in combination with our positions in high yield bonds and leveraged loans and is aimed at offsetting credit risk in the portfolio. The hedge fund sub-portfolio totals 23 per cent of Modern Protection, with an emphasis on Market Neutral and Multi-Strategy.

Given these changes, the Modern Protection portfolio should be able to withstand a period of market turmoil, but we will monitor developments in the credit market carefully to make any further adjustments in our positions.



MODERN GROWTH

Risk assets opened the year strongly and rose sharply during the first few months, but since mid-March they have been in a falling trend. As we feared in the last *Investment Outlook* (published February 21, 2012), April macro data from the US have been weaker than expected. Worries about the euro zone have again increased – this time focusing on Spain. Looking eastward, statistics from China's manufacturing sector are signalling slower activity, and investors are increasingly concerned about a possible hard landing in the Chinese economy.

On the whole, our view of the global economy has not changed significantly, but we believe that the risk of an overall recession in the OECD countries has increased somewhat. We also expect emerging markets, especially in Asia, to remain as the growth engine of the global economy and that the OECD countries will not achieve their potential growth rate. An expanding economy does not, however, necessarily mean a rising stock market. Most US economic growth now seems to be priced into equities, and markets are not enjoying the same support from macro data. During the next quarter, company-related news and euro zone worries are likely to be the main market-driving factors, along with any interventions by central banks (mainly the US Federal Reserve's possible launch of QE3).

This means that we have lowered our return expectations for risk assets. Early in April we decreased our most cyclically sensitive positions. In equities, we halved our exposure to emerging markets and increased our exposure correspondingly to global equities. In this way, we are keeping the equities sub-portfolio at an unchanged 17 per cent of Modern Growth but are reducing the riskiest exposures. Global equities now total 12 per cent, while Nordic and emerging market equities together total 5 per cent of Modern Growth.

Based on analysts' estimates, stock market valuations are reasonable and low interest rates indicate that equities may climb even more, but profit margins are historically high. Looking ahead, corporate profits may be squeezed by persistently high oil and other energy prices, and we see a risk that higher costs and lower profit margins may eventually push down valuations. In today's climate of low underlying economic growth, it is thus especially important – but difficult – to find companies that are growing.

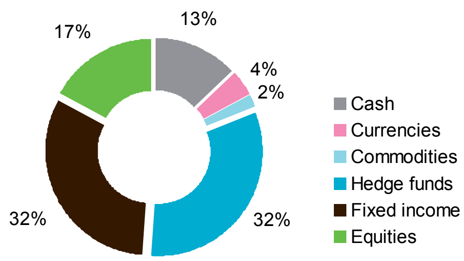
Given weaker global growth, commodities are also under pressure. Weak Chinese growth decreases demand for industrial metals, for example, but agricultural producers appears likely to enjoy good harvests this year, with relatively favourable weather forecasts. Because of this mixed outlook, we have generally decreased our commodities exposure, which now totals 2 per cent of Modern Growth.

We still foresee the best risk-adjusted return in corporate debt. The underlying arguments are the same – banks must shrink their balance sheets, and companies increasingly choose to borrow in the bond market instead of via banks. The corporate debt segment is growing, while companies have strong balance sheets. Although Moody's rating agency raised its forecast for global credit events (the default rate, for example bankruptcies and restructurings), it remains below the 5 per cent historical average. Meanwhile the bond market is pricing in a default rate of nearly 8 per cent. The yield spread to government bonds has admittedly narrowed steadily since year-end 2011, but the level is still attractive. We are keeping our corporate debt exposure at 30 per cent.

In the fixed income sub-portfolio, however, we halved our emerging market bond position in local currencies. Although their high yields remain attractive, in a shaky market, capital will seek out "safe" currencies like the US dollar, with weaker EM currencies as a consequence. If the Fed launches a new round a quantitative easing in the second half of 2012 (as we have forecasted), the USD is likely to weaken, but stable industrial data from the US will lower the probability of new intervention. In the long term, the arguments in favour of EM debt are still valid, but in light of short-term uncertainty and general market sentiment we have lowered our exposure to 2.5 per cent.

Since the beginning of 2012, the hedge fund sub-portfolio has shown limited growth. Although Event Driven and Multi-Strategy have performed favourably, CTA strategies (where we have our largest allocation) have lost ground. Hedge fund managers, especially CTA managers, have generally found it hard to generate returns recently due to increasingly high correlation between assets, as well as rapidly fluctuating trends. In April we increased our allocation to Credit L/S, which tends to perform well when the credit market generally declines. This position should be seen in combination with our large exposure to high yield bonds.

On the whole, the Modern Growth portfolio is more defensively positioned than one quarter ago, in order to withstand a period of more turbulent markets. However, we are prepared to reduce its cyclical sensitivity even more if the outlook for our asset classes deteriorates.



MODERN AGGRESSIVE

This year's sharp upturn in risk assets ended in mid-March. Since then these assets have been in a falling trend. The VIX volatility index, often viewed as a measure of investors' risk aversion, fell below 15 in March and then rebounded to above 20 in early April. At this writing, the index is again at around 16. Historically (since 1990), the VIX has reached levels below 11 on a number of occasions, but today's levels are in the lower interval since the financial crisis began. Without drawing any academic conclusions, we can note that on several occasions since 2007 the global stock market has fallen by more than 10 per cent after the VIX hit new lows. In a way, low VIX readings can thus be viewed as the calm before the storm, which is another reason for our more reserved attitude towards risk at present.

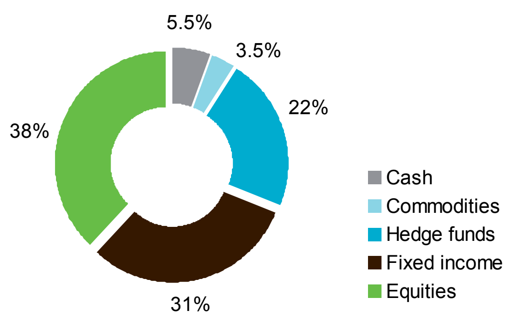
Although our view of the global economy has not changed significantly, after the strong upturn we lowered our return expectations for risk assets. Early in April we decreased our most cyclically sensitive positions. In the equities sub-portfolio, we halved our exposure to emerging markets and increased our exposure correspondingly to global equities. In this way, we are keeping the sub-portfolio at an unchanged 38 per cent of Modern Aggressive but are reducing the riskiest exposures. Global equities now total 26 per cent, while Nordic and emerging market equities together total 12 per cent. Our holdings of global equities are generally targeted towards niche markets that have growth potential even in low-growth economies, such as Asian private consumption as well as certain companies in the technology sector.

Market worries about a hard landing in the Chinese economy have gradually increased, also putting pressure on commodities. Weak Chinese growth decreases demand for industrial metals, for example, whereas agricultural producers appear likely to enjoy good harvests this year, with relatively favourable weather forecasts. Because of this mixed outlook, we have generally decreased our commodities exposure, which now accounts for 3.5 per cent of the portfolio.

We still foresee the best risk-adjusted return in corporate debt. The underlying arguments are still the same – banks must shrink their balance sheets and companies increasingly choose to borrow in the bond market instead of via banks. The corporate debt segment is growing, while companies have strong balance sheets. Although Moody's rating agency raised its forecast for global credit events (the default rate, for example bankruptcies and restructurings) to 3 per cent in 2012, this is still below the 5 per cent historical average. Meanwhile the bond market is expecting a default rate of about 8 per cent. The yield spread to government bonds has admittedly narrowed steadily since year-end 2011, but the level is still attractive. We are keeping our corporate debt exposure at 22 per cent.

Since the beginning of 2012, the hedge fund sub-portfolio has shown limited growth. Although Event Driven and Multi-Strategy have performed favourably, CTA strategies (where we have our largest allocation) have lost ground. Hedge fund managers, especially CTA managers, have generally found it hard to generate returns recently due to an increasingly high correlation between assets, as well as rapidly fluctuating trends. In April we also added the Credit L/S strategy, which tends to perform well when the credit market generally declines. This position should be seen in combination with our large exposure to high yield bonds.

On the whole, the Modern Aggressive portfolio is more defensively positioned than one quarter ago, in order to withstand a period of more turbulent markets. However, we are prepared to reduce its cyclical sensitivity even more if the outlook for our asset classes deteriorates.



Austerity or growth – or both

- *Today one-sided austerity policies face growing resistance and scepticism...*
- *... while measures aimed at promoting growth have moved to the top of political agendas*
- *There are also recipes in which austerity paves the way for growth*

The financial decline of the public sector in many of the OECD industrialised countries has been under way for decades, as under-balancing of budgets to sustain growth during slow-downs has not been matched by equally large over-balancing during boom periods. Economist John Maynard Keynes' fiscal pump-priming recipe has thus not been followed to the letter.

Government debts in many countries have consequently trended higher during the post-war period, both in absolute terms and as a percentage of gross domestic product (GDP). By the turn of the millennium, overall government debt in the OECD countries had grown to about 65 per cent of GDP. Their income statements – or budget balances – were meanwhile in the red, but at that time these negative figures were not especially large: 1-2 per cent of GDP.

After that, the situation worsened dramatically because of the financial and economic crisis that began in 2007 due to sub-prime mortgage problems in the US. Later – through various channels – it spread like wildfire across the US and the global economy. The crisis culminated in the spring of 2009. By then, public budget deficits in the OECD countries had literally exploded, as countries were forced to enact fiscal emergency programmes to rescue their financial systems and industrial sectors, and as a deep recession caused government revenues to fall and expenditures to climb.

Within a few more years, public sector debt in the OECD countries had swollen to nearly 100 per cent of GDP. Public debt of this magnitude leads to major problems, including high bond yields, rising costs of funding for banks and increased restrictiveness in bank lending. Taken together, all of this hurts economic growth.

The unprecedented deterioration in public finances made budget austerity measures inevitable. In most cases this was forced on governments, mainly by the financial market, the International Monetary Fund (IMF) and the European Union (EU). In exchange for tough budget measures, several euro zone countries have received bail-out loans from the "troika": the EU, the European Central Bank (ECB) and the IMF. Massive downgrades of many countries' creditworthiness by bond rating agencies have also helped intensify pressure for public budget consolidation.

Tough belt-tightening in all cases

In Europe, the GIIPS countries – Greece, Ireland, Italy, Portugal and Spain – have been the focus of attention. But while Greece, Ireland and Portugal were forced to apply for bail-outs from the EU/IMF, Italy and Spain can still fund their budget deficits with loans in the ordinary fixed income market – though at high bond yields (SEB forecasts that Spain will soon need a bail-out, however). In all cases, these countries have had to submit to tough belt-tightening. They have also been required to take steps to improve the functionality of their economies and their international competitiveness.

During the third quarter of 2011, financial market worries climbed steeply as the sovereign financial problems of countries like Greece, Italy and Spain escalated – new governments soon took office in both Italy and Spain – and the credit rating of the US federal government was downgraded.

In the wake of this market drama, there was a nascent ambition to boost the lending capacity of the euro zone's European Financial Stability Facility (EFSF). In March 2012 euro zone finance ministers reached agreement on a temporary "financial firewall" of EUR 800 billion. By the end of 2011 the ECB had also realised that the euro zone banking system had an acute need for financial support. The ECB thus offered banks a round of three year loans in December and a second round in February. These banks borrowed a gross amount of about EUR 1 trillion from the ECB.

Last year's financial market turmoil also led to a process for developing a new tool for tougher budget discipline in the EU.

In January this resulted in a new EU "fiscal compact", requiring countries to cap their public deficits at 0.5 per cent of GDP and specifying the possibility of sharp sanctions against those that break this rule.

As a consequence of the 2007-2009 financial and economic crisis and the accompanying dramatic deterioration in public finances, today's economic policy landscape in Europe is now characterised by:

- Record-low key interest rates and other forms of monetary policy support (low-interest loans, bond purchases etc.)

- Sizeable bail-out funds (the EFSF and the European Stability Mechanism, or ESM), with IMF money in the background

- Unusually strict budget policies – which are supposed to be tightened further with the help of the fiscal compact – aimed at reducing unreasonably large and harmful public budget deficits as well as debts

- Structural policies aimed at enabling economies to function better and become more competitive

Stimulus and support from euro zone monetary policy have only managed to offset tight budget policies to a certain extent. As a result, in the past six months the GIIPS countries in particular have noted rapidly declining GDP, steeply rising unemployment and growing discontent and austerity-fatigue among households and businesses. During the winter, the overall euro zone economy teetered on the brink of recession. The risk of recession cannot be ruled out.

This discontent, especially in southern Europe, has found outlets in the form of demonstrations – in many cases violent, with major property damage – and strikes called by trade unions, as well as via elections, most recently the presidential election in France and the parliamentary election in Greece on May 6.

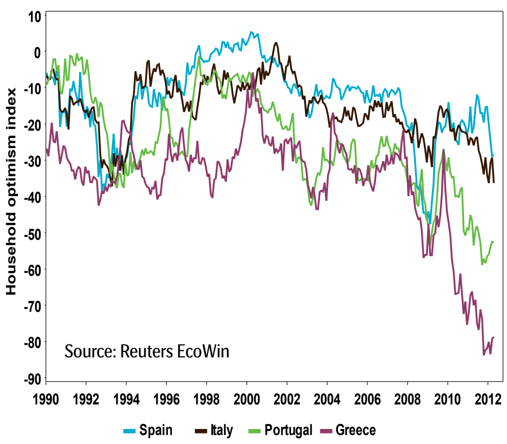
In France the right-of-centre president, Nicolas Sarkozy – who supported budgetary discipline and worked closely with Germany's "strict" chancellor, Angela Merkel – was defeated by the more growth-oriented Socialist leader François Hollande. In Greece, the two parties associated with the harsh budget policies and sacrifices of the past year – Pasok and New Democracy – suffered major defeats, while protest parties on both the far left and far right achieved considerable electoral success. After several attempts to form a new government failed, a new election has been set for June.

Another example of the new winds that have begun to blow is the Dutch government crisis of late April. It was triggered when the right-wing populist Freedom Party, which had supported Prime Minister Mark Rutte's minority government, refused to accept austerity measures needed to bring the Netherlands' budget deficit below 3 per cent of GDP by 2013. This incident shows that efforts to restore fiscal order have generated opposition even in a country that has been Germany's ally in promoting an austerity approach. When Angela Merkel's CDU party later suffered a devastating loss in the North Rhine-Westphalia state election, this demonstrated that not even Germans approve of austerity.

Affected by this sudden loss of momentum in pursuing tighter austerity policies, the EU – cheered on by the IMF – has also indicated the possibility of adopting a more growth-oriented policy. It remains to be seen how the ECB – which is obviously worried that political leaders will slow the pace of austerity and reforms – will react to such a move.

At the top political level of the EU, European Council President Herman Van Rompuy has summoned an informal extra EU summit on May 23 aimed at putting growth and job creation on the European political agenda.

One "tactical" argument for initiating EU level discussions on growth and the conditions for promoting it might have a



SPRING OF DISCONTENT SWEEPS SOUTHERN EUROPE

A renewed deep economic slump, dramatically rising unemployment and tough public budget cutbacks have spoiled the mood of households in southern Europe, especially Greece. One reaction has been violent demonstrations and widespread strikes.

bearing on the change of leadership in France, as well as the fact that the economic growth conditions are much worse in France than in Germany.

During the French election campaign, Hollande launched proposals to raise taxes on high incomes, wealth and French businesses – especially the financial sector – but also to enact expansionary fiscal programmes such as hiring new teachers in the public sector and boosting minimum wages. Yet the differences between Hollande and Sarkozy in terms of their ambitions for the government budget trend over the next couple of years are fairly small on the bottom line. Hollande more enthusiastically advocates using the tax weapon to shrink the deficit, with the aim of balancing the budget by 2017. History also shows that periods of Socialist rule in France have not meant poorer budget discipline than when the political right has been in power.

Hollande wants tools to promote growth

The reason why Hollande is nevertheless viewed as a threat to budgetary discipline, which has been the economic policy lodestar in Europe for some years, is that during the campaign he promised that as president he would renegotiate the new fiscal compact. He later modified this, saying that the compact must be supplemented with tools to promote economic growth. If the EU shifts its focus more towards growth and its driving forces, Hollande may conclude that France's neighbours are trying to meet him halfway and may then more easily accept previously signed agreements.

Hollande's political agenda is actually contradictory, since budget consolidation based largely on tax hikes is directly contrary to his growth-boosting ambitions. This is because the tax burden in France is already at a level that undoubtedly hampers economic expansion and competitiveness. Total taxation of labour is equivalent to 18.5 per cent of GDP in France compared to less than 17 per cent in Germany, while total indirect taxes amount to nearly 15 per cent and just over 11 per cent of GDP, respectively.

These differences in taxation have obviously affected French competitiveness in terms of unit labour costs, which have risen 28 per cent in France since 2000, compared to 5 per cent in Germany. Cost increases in France are thus not especially far behind those of some GIIPS countries. Unless French businesses are offered far better competitive conditions by cutting taxes and implementing structural reforms, it is difficult to see how the euro zone can stay together in the long term.

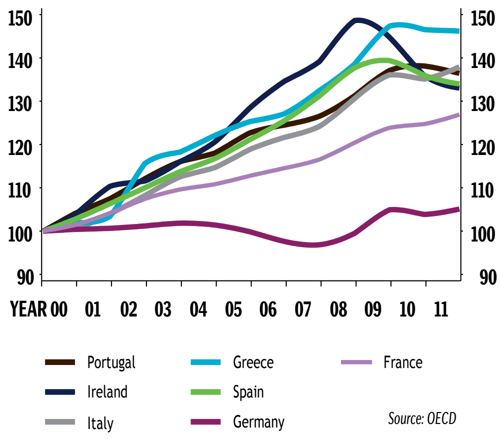
Structural reforms that promote growth – at supranational and national level – are becoming the focus of economic policy debate in Europe, now that the role and the value of one-sided austerity measures are increasingly being questioned. Public sector belt-tightening, which is nevertheless necessary, is thus likely to gradually be stretched out over a longer period. For example, Italy recently halted various planned tax increases, replacing a planned value-added tax hike with cuts in government outlays.

According to Hollande's statements, a "growth compact" should include 1) launching Eurobonds to finance infrastructure projects, 2) larger resources and lending capacity for the European Investment Bank, 3) introduction of a financial transaction tax ("Tobin tax") and 4) more efficient utilisation of EU structural funds. If Hollande gains support for a growth compact, all indications are that he may well abstain from pursuing the issue of renegotiating the fiscal compact.

Hollande has also appealed to the ECB to play a more active role in promoting economic growth. Worth noting is that for some time, the IMF has recommended an increase in the ECB's inflation target from today's figure of just below 2 per cent. This would enable the ECB to provide further stimulus via its refi rate and perhaps also buy sovereign bonds in the secondary market (via its Securities Markets Programme, SMP).

Structural reforms – a concept closely associated with growth – are primarily aimed at improving the functionality of markets for goods and services as well as production factors and increasing exposure to competition. The objective is to raise long-term productivity – output per hour worked – thereby boosting the growth potential of an economy.

GERMANY HAS BY FAR THE BEST COMPETITIVENESS



Over the past decade, German unit labour costs have risen by a modest 5 per cent, compared to nearly 30 per cent in France and 35-45 per cent in the GIIPS countries. If the euro zone is to stay together long-term, these differences must narrow. In addition to budget consolidation, this will require measures that enable economies to function better and become more competitive.

Alongside tough budget austerity measures, Spain and Italy have launched policies aimed at making their labour markets function better and more efficiently. For example, Spanish companies that suffer major business reversals can more easily extricate themselves from collective agreements and cut employee working hours.

So far, ongoing discussions among politicians and economists have mostly concerned the choice between austerity and growth. But there are actually examples of how austerity policies have paved the way for – and gone hand in hand with – increased economic growth. According to the familiar Keynesian theory, budget austerity via higher taxes and/or cuts in government expenditures lead to lower GDP growth. This is challenged by the "German school" (*German Council of Economic Experts, 1981*), which argues that tighter budget policy focusing on reduced expenditures should be viewed as a premise for expansion rather than recession, since lower public sector demand makes room for private sector expansion.

Later both theoretical approaches were combined, and expectations were assigned a central role (*Hellwig/Neumann, 1987, "Economic Policy in Germany: Was there a turnaround?"*).
The direct impact of budget austerity is of course negative in terms of growth (Keynes). But if austerity is perceived as part of a credible programme for restoring order to government finances and is expected to eventually lower the public sector's share of GDP, expectations of future lower taxes may stimulate private demand even today (the German school).

Evidence that austerity measures have led to faster growth can be found in a well-known analysis of Danish and Irish budget consolidations that occurred in the 1980s (*Giavazzi/Pagano, 1990, "Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries"*). Although public spending was cut and taxes were dramatically raised in Denmark, private consumption rose significantly in the wake of a sharp upturn in consumer confidence, which among other things was a response to expectations of lower future taxes. In Ireland, however, private consumption fell concurrently with austerity measures, apparently because households could only marginally offset falling income with consumer loans and reduced saving, which the Danes could do to a much greater extent.

Given the above background, the key task for European political leaders should thus be to create confidence and positive expectations among households and businesses, in order to generate demand for consumption and capital spending. The tools and methods for achieving this have already been described extensively, but to summarise:

- The still-necessary restoration of order to public finances – focusing on spending cuts, not tax hikes – must be perceived as credible and successful in the long term by households and businesses, and must be supplemented with tools that improve economic growth and competitiveness.

- Often economically painful actions must be understood and supported by the citizenry, and both the burdens and benefits of these policies must be allocated in a way that is perceived as fair; the "democratic deficit" must decline significantly.

- There must be consensus at the EU level – especially between Merkel and Hollande, "Merkollande" – about the economic policy agenda. There must be clarity about what tasks and objectives EU institutions including the ECB should have, and there must be unhesitating support for budget discipline measures (the fiscal compact) as well as growth-promotion measures (the growth compact).

But measures that may seem economically desirable and those that are politically feasible are of course often not entirely compatible. The winds now blowing in the political world and among some economists, together with growing austerity-fatigue, may very well lead to a greater focus on easing public belt-tightening requirements coupled with less of a focus on long-term growth promotion reforms than is desirable. Nor, perhaps, will recipes rooted in the 1980s have as great an impact on the economic environment of our current decade.

WHERE POTENTIAL FOR REDUCED PRIVATE SAVINGS IS FOUND WHEN CONFIDENCE INCREASES

Country or zone	Public net lending/% of GDP, 2011	Private saving/% of GDP, 2011
Euro zone	-4.1	+3.7
Germany	-1.0	+5.9
Netherlands	-4.7	+12.5
Belgium	-3.7	+3.2
France	-5.2	+2.9
Italy	-3.9	+0.4
Spain	-8.5	+4.5
Portugal	-4.2	-3.8
Greece	-9.1	+0.5
Ireland	-13.1	+13.6

Source: Eurostat

Most euro zone countries have initiated tough public belt-tightening, aimed at reducing their large budget deficits. While their public sectors are uniformly in the red, most countries – except Portugal – show positive saving in the private sector (households and businesses). If economic policy were capable of creating confidence and greater optimism among households and businesses, many countries thus have major potential to reduce their private saving, thereby boosting consumption and capital spending.

Is the upturn in listed company margins a bubble?

- *Are high margins a profit bubble?*
- *The business sector and companies have changed*
- *Distinguish between structural and cyclical fluctuations*

The operating margins of Nordic listed companies have steadily trended upward for at least the past 20 years. This pattern is generally familiar both in the Swedish business sector and in many places internationally. Is it a profit bubble? And it is ready to burst?

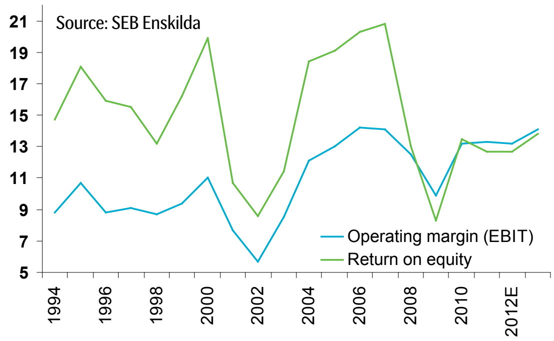
A seemingly high potential profitability decline, in case of a reversion to the average margins for the past 15 years – combined with expected low growth in Europe and continued high commodity prices – leads many observers to intuitively answer yes to the above questions. It is worth recalling, however, that as early as the time of the Lehman Brothers crash (autumn 2008) and the weak earnings trend that followed directly afterward, many people drew the same conclusion. That time around, it only took until 2010 before the companies on the Nasdaq OMX Stockholm exchange achieved new record-high margins. This rapid recovery was not only a function of aggressive economic stimulus policies, which have now reached their end. We believe that the reality is more complex and that there are structural changes that explain why a return to historical average margins should not be taken for granted.

Returns attract capital

There are many ways to measure the profitability of companies. Profit margin measures how large a company's profit is in relation to its sales revenue, while return on capital employed measures profits in relation to the capital that has been invested in order to generate equivalent returns. Theoretically, high profits should attract new investments to an industry – increasing competition, pushing down prices and causing profitability to normalise again. But high return on capital is what attracts new capital, not the margins on sales. For example in a real estate company, a substantially larger share of revenue needs to be pure profit (to justify an investment) than is true of a wholesaler. In the same way, the extensive costs, risks and time required to develop a new pharmaceutical require this product to return higher margins than a new toothpaste.

Nordic listed companies have greatly improved their operating margins in the past two decades, but no corresponding increase is visible in returns. Returns on both capital employed and equity show a sideways movement, with cyclical fluctuations caused by changing economic conditions.

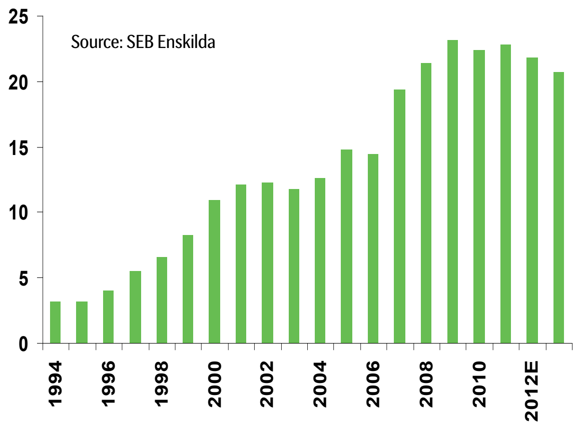
MARGINS ARE RISING, BUT RETURN ON EQUITY KEEPS FLUCTUATING IN THE SAME RANGE



Operating margins have been rising for a long time, but do not reflect a margin bubble. Meanwhile return on equity has fluctuated, signalling more capital-intensive sales. The chart shows the aggregate return on equity and operating margin at Nordic listed companies in per cent.

Sales seem to have become more capital-intensive, thus requiring higher margins to maintain the same profitability. If we look more closely at balance sheets, it is especially apparent that the quantity of intangible assets has increased dramatically. In relation to sales, intangible asset have doubled in 10 years and more than quintupled in 20 years. Intangible assets come partly from capitalised research and development investments, but goodwill originating from various restructuring transactions also often reflects the fact that a corporate group owns valuable intangible assets – which would have been costly to obtain even if they could have been built up organically instead of via acquisitions.

COMPANIES HAVE INVESTED HEAVILY IN INTANGIBLE ASSETS



The above bar chart shows the intangible assets of Nordic listed companies as a percentage of sales.

Research and development as well as soft factors such as trademarks, designs and customer relations are of great significance in most sectors. Barriers to new competition or market positions are also very important. Sizeable investments are required in these areas. Even though they are "intangible", these investments must of course also provide a return. We believe that the dramatic increase in the percentage of intangible assets in balance sheets reflects their increased importance to companies in recent decades.

Two sides of the same coin

When companies describe the above transformation, they rarely do so with a philosophical approach. However, we can find numerous investor presentations about how companies have focused and should continue to focus on high-margin products, more services and after-market sales. They make efforts to expand in market segments where the company generates more customer value, while phasing out low-margin products. Familiar examples are Sweden's largest vehicle manufacturer, which shifted away from the extremely competitive passenger car industry – where it was a smaller player – to become one of the largest global players in heavy trucks. A large industrial bearing manufacturer has carried out the same kind of dramatic change in its product range and pricing policy. One small industrial conglomerate has been transformed from a maker of simple components with non-existent software content to a globally leading supplier of advanced measuring technology, in which software is the main product. A rubber and plastics manufacturer has rapidly shifted its product range away from high-volume products for extremely price-sensitive customers towards products incorporating many patents and customer categories that prioritise quality and delivery assurance higher. For many years, Sweden's largest compressor manufacturer has used value added, energy savings and service as sales arguments ahead of price. Numerous companies have undergone transformations in this direction.

Sectoral trends influence aggregates

The average margin in the Nordic countries is also affected by shifts in the relative size of different sectors. For example, the health care sector has grown somewhat faster than average. Another sector with relatively high margins and high capital intensity and whose importance has greatly increased in the Nordic region, thereby helping boost the average margin, is the oil industry.

Short-term expectations

In addition to the above-described structural changes, a number of factors can be expected to influence margins in the near term. Margins of companies on the Nasdaq OMX Stockholm fell somewhat in the first quarter of 2012 compared to a year earlier, but it is important to distinguish between cyclical fluctuations and structural changes. It would be highly remarkable if the recession elsewhere in Europe had not impacted margins this year. For the full year, we expect margins to shrink by one percentage point in Sweden, but as early as 2013 most of this downturn will be recovered.

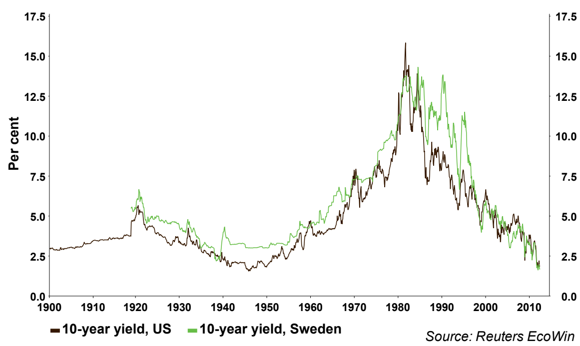
Factors such as exchange rates and commodity prices also affect margins in the short term, but not always in the way that the prevailing perception would indicate. For example, higher commodity prices in recent years have coincided with better margins at mechanical engineering companies and vice versa.

In search of lost returns

- *Bond yields are probably past their low point*
- *Government bonds are no longer risk-free*
- *High yield, EM bonds and high-dividend shares are attracting investors*

Long-term government bonds in the OECD countries have historically tended to move in 30-year cycles. During the past 30 years, yields on government bonds have fallen and bond prices have risen. The preceding 30-year period, in contrast, was characterised by rising bond yields and falling bond prices. And before that, we had 30 years of falling yields and rising prices. If the 30-year cyclical pattern persist, we are soon likely to enter a long period when government bond yields in the Western world will trend upward. And there are many indications that this will be the case.

30-YEAR CYCLES FOR GOVERNMENT BONDS



Government bond yields have historically tended to move in 30-year cycles. There are many indications that yields have bottomed out this time around and that we are moving into a long period of rising yields.

As a consequence of the latest financial crisis, yields on government bonds with both short and long maturities have been squeezed down to artificially low levels. We are seeing what happens when influential central banks have lowered their key interest rates towards zero. They have also launched sizeable stimulus packages, including massive government bond purchases. But the ammunition in monetary policy weapons is now largely exhausted, and bond yields are probably past their lows this time around.

Poorer credit quality

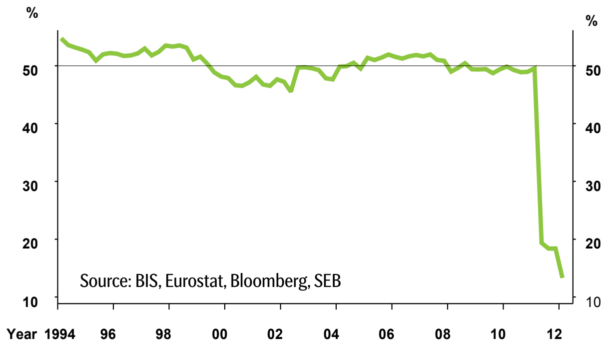
At the same time as government bond yields have moved downward, sovereign debt has increased sharply. Just over 20 years ago, the total quantity of bonds equalled 80 per cent of world GDP. By 2010 that figure had climbed to 150 per cent of world GDP. Above all, government debt has increased.

For a long time, this increased debt burden passed unnoticed in credit agencies' bond ratings. But a greater focus on country risk and the knowledge that even a country can go bankrupt have caused the rating agencies to act. In the past year, the credit quality of the world's overall public sector debt has dramatically worsened. This trend becomes clear if we look at all the public sector bonds of the 20 countries in the world with the largest public debts. Until 2011, about half of the global public bond supply carried the top credit rating, AAA. At present, only 13 percent of the total supply carries this rating.

We are in a situation where most Western governments are borrowing at record-cheap rates, while their overall credit quality has never been worse. A justifiable question is: For how long will investors accept zero returns on the capital they lend to these debt-ridden borrowers?

No longer a good risk-diversifier

One reason for buying government bonds has been that historically, they have served as a good form of protection in investor portfolios. In the past two decades, there has been a negative correlation between equities and bonds; that is, when equities have fallen in values, bonds have risen and vice versa. Aside from preserving the value of capital during periods of falling stock markets, government bonds have also been a good investment in themselves, since bond prices have risen. This explains why an investment strategy of 60 per cent equities and 40 per cent bonds has historically generated a clearly higher risk-adjusted return than the stock market



FEWER COUNTRIES WITH TOP CREDIT RATINGS

The credit quality of the world's overall public sector debts has worsened dramatically in the past year. The share of countries with the highest sovereign bond credit rating has fallen from 50 to 13 per cent since 2011. The curve shows the share of AAA-rated public bonds as a percentage of total government bonds in circulation.

alone. But the room for continued decline in yields from today's levels is practically non-existent. And in an investment climate where real-term yields are negative in many cases, the diversification benefits are likely to be small. Instead there is a clear risk that government bonds will contribute negatively to the return on the portfolio as their attractiveness wanes.

Less exposure, given the opportunity

One type of financial market player that traditionally holds a large percentage of government bonds is pension funds. The main reason why government bonds with long maturities have been attractive to them is that regulatory authorities require life insurance companies to match the maturities of their assets with those of their liabilities. Another clear advantage is that such bonds have been viewed as "risk-free", with life insurance companies "guaranteeing" a certain return on capital. In principle, the lower the yield, the more capital life insurance companies must "secure" for the yields to add up to the amounts they have promised to pay investors.

Today's extremely low yields make it difficult for life insurance companies (the main private pension fund vehicles in Sweden and elsewhere) to meet their obligations to pensioners, in terms of return requirement. It is also worth asking whether government bonds are risk-free. Pension funds thus find themselves in something of a tight spot. They would need to reduce the percentage of government bonds in their portfolios to achieve the promised returns, while regulations require a large exposure to this asset class. If regulations become more flexible, life insurers are likely to reduce their exposure to government bonds.

On the whole, government bonds issued by Western countries appear to be an unattractive asset class. There are many indications that the past 30 year period of falling yields has come to an end. Receiving no return on assets may be considered acceptable for short periods when the market is panicking and investors wish to park their capital somewhere while awaiting better times. But in the long term, it is not sustainable. It is thus probably merely a matter of time before the investor community chooses to drastically reduce its government bond allocation. This would lead to falling bond prices and thus rising yields.

In search of higher returns

Investors not receiving any returns from government bonds are searching for fixed income securities with better potential returns. Corporate bonds have become popular, increasingly often replacing government bonds in investor portfolios. What attracts investors is that corporate bond yields, especially in the "high yield" segment (companies with low creditworthiness according to rating agencies) are substantially better than the yields on government securities. The yield gap between the two has widened due to the financial crisis. Whereas corporate bonds are traded at about the same yields as before the financial crisis, government bond yields today are far lower.

Compared to the threadbare finances of many OECD countries, companies also demonstrate significantly better solvency. At an aggregate level, companies deliver large profit and have meanwhile cut costs and built up a large liquidity buffer to avoid problems if the business situation deteriorates.

EM bonds – higher yields and lower credit risks

Another fixed income asset class that increasingly attracts investors is emerging market (EM) bonds. Here too, yields are on a par with pre-financial crisis levels and are now well above yields in OECD countries. This is despite the fact that Western countries generally have substantially larger budget deficits and much heavier government debts. Overall government debt in OECD countries is climbing towards 100 per cent of GDP, while in emerging markets it is falling towards 30 per cent of GDP. The reasons why yields on EM bonds are nevertheless so high are that EM sphere inflation is comparatively high and the market has historically considered it riskier to lend money to EM countries. And in some cases, a certain risk premium can be justified by larger social and political risks than in the West, but we believe that these risks are generally priced too high.

When buying EM bonds, the investor also gains exposure to EM currencies. An estimated two thirds of total return comes from the currency effect, while one third comes from the yield on the investment. Looking ahead, most indications are that EM currencies will keep trending upward in relation to OECD currencies. But currency exposure also means that, in terms of standard deviation, the investment is riskier. The total risk for EM bonds is thus somewhat larger than for high yield bonds.

Both high yield and EM bonds are risk assets by nature. They should thus mainly be compared to equities, not to traditional fixed income investments. In the past 20-25 years, the trend of high yield and EM bond valuations has matched that of equities, but volatility (risk) has been far lower. These two high-yielding assets have thus historically offered a significantly higher risk-adjusted return than the stock market. Since the correlation between high yield and EM bonds is comparatively low, it is advantageous to invest in a combination of these two asset classes.

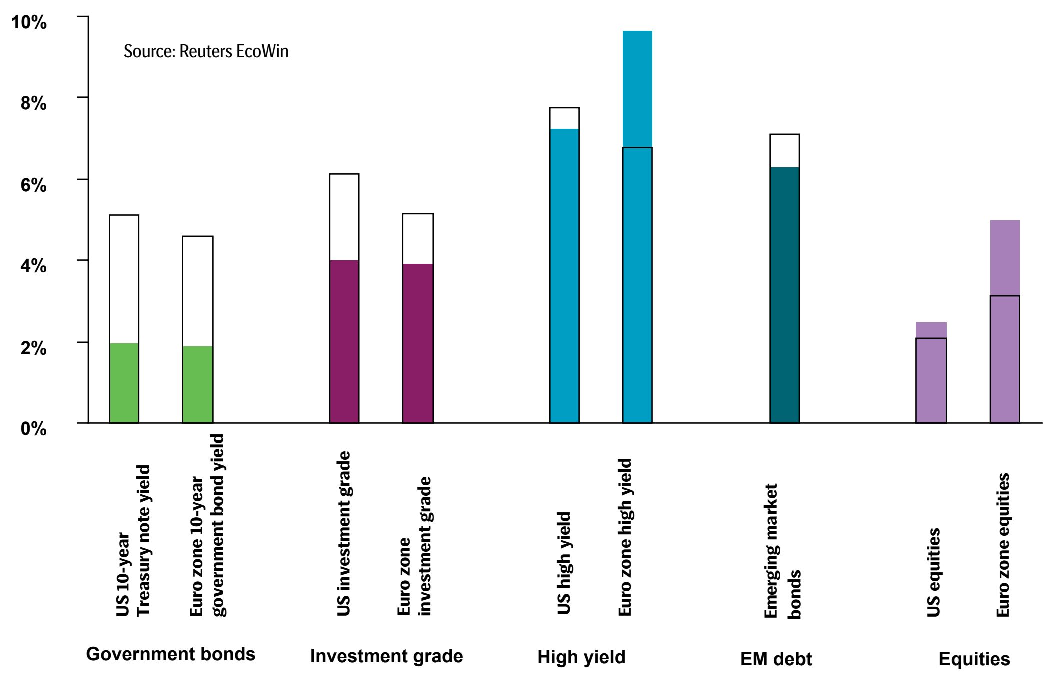
High-dividend equities attracting investors

In the search for returns, high-dividend equities are another attractive alternative. Company shares that can deliver dividend yields that exceed long-term government bond yields by a good margin should generally be considered worth buying. At present, dividend yields for such companies are generally more than twice as high as 10-year government bond yields and in many cases significantly more. A basket of high dividend-yielding equities may thus be a good alternative, but investors should be aware that the price movements on equities are generally very large.

Company	Country	Dividend yield, 2012 forecast
Tele2	Sweden	12.2
NCC	Sweden	7.3
TeliaSonera*	Sweden	6.5
UPM	Finland	7.2
Fortum	Finland	5.5
Stora Enso	Sweden	6.3
Stolt-Nielsen	Denmark	5.6
Fabege	Sweden	5.3
Securitas*	Sweden	6.1
Metso*	Finland	6.1
Huhtamaki	Finland	4.0

*During the past 12 months, SEB has performed corporate finance assignments for this company.

INVESTORS ARE LIKELY TO SEEK THE HIGHEST RETURNS



The chart shows direct yields on different asset classes before the financial crisis (in colour), along with current levels (in white). All indications are that investor preferences are shifting away from government bonds of OECD countries to riskier asset classes in search of better returns. The returns on high yield bonds and EM debt are still attractive compared to their pre-crisis levels.

Green investment diversifies a portfolio

- *Forestland investments complement traditional portfolios*
- *Major price differences between Baltic Sea countries*
- *World population is growing, while forestland is shrinking*

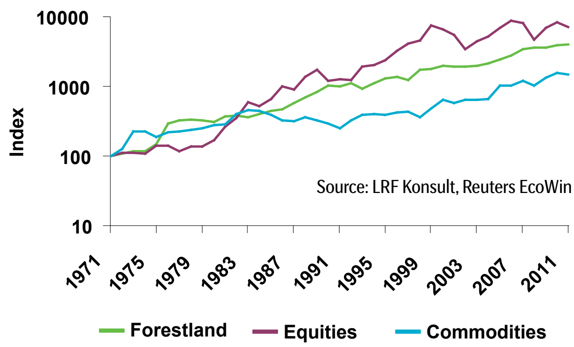
During periods of ongoing financial market turbulence, there is a greater need for alternative investments to diversify from risky assets in traditional portfolios. Uncertainty about euro zone stability, global growth and energy price trends leads us spontaneously to alternatives that are more predictable. As described below, forestland is an asset with highly predictable returns, lower risk than equities and a negative correlation to various similar sources of returns.

If we view forestland as an investment, we think about potential returns from this land: the commercial value of forest products and the value of other assets such as hunting, fishing and recreation. Forest products grow steadily and independently of economic cycles. Thanks to modern forestry methods, dedicated managers and better infrastructure, it is easier than ever to treat forestland as an investment.

Over the past 40 years, Swedish forestland has steadily risen in value at an annual rate of 10.8 per cent. During the past decade, amid great activity, Swedish forestland prices have doubled. Compared to annual returns on equities and commodities, we see that Swedish forestland has not only provided very good returns but also lower risk and has been a perfect diversification asset. From the 1970s until today, forestland has had a negative correlation with equities (-0.152) as well as commodities (-0.090).

The chart and table to the right illustrate the indexed price trend for Swedish forestland, the Affärsvärlden General Index (AFGX) of the Swedish stock market and the Dow Jones UBS Commodity Spot Index (SEK). All three have shown strong growth during the period, and a close look at forestland indicates that it has the lowest volatility and an apparently negative correlation with the others. If we replace the AFGX with the US-based S&P 500 Composite Index in SEK (annual rate 9.5 per cent), the chart would also show Swedish forestland paying the highest return of the three asset classes.

PRICE TREND, FORESTLAND VS OTHER MARKETS



Over the past 40 years, Swedish forestland has provided an average annual return of more than 10 per cent, with far smaller fluctuations than the stock market, according to a study by Thomas Lusth of LRF Konsult. Forestland investments have shown a very favourable correlation with both equities and commodities.

		Forest-land	Equities	Commodities
Correlation	Forestland	1		
	Equities	-0.152	1	
	Commodities	-0.090	0.183	1

	Forest-land	Equities	Commodities
Avg annual return (%)	10.8	14.6	8.7
Standard deviation*,%	17.8	27.3	20.3
Sharpe ratio**	0.50	0.46	0.33

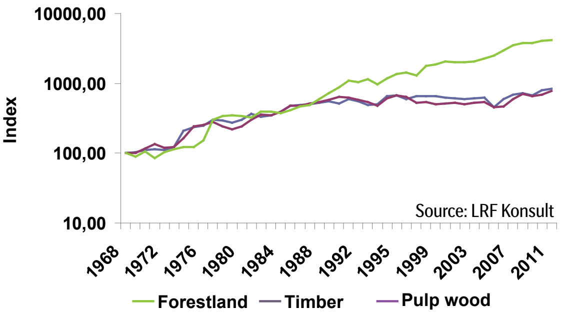
* Calculated using annual data, 40 measuring points.
**Risk-free interest 2.0%.

One reason for the strong price increase on Swedish forestland is the price performance of forest products – timber and pulp wood. Commodity prices may vary in the short term due to such factors as supply, demand, market trends, quality differences and geographic differences. Over the past 40 years, prices of the most common forest products (timber and pulp wood) has shown average annual price increases of 5.9 and 5.6 per cent, respectively (measured in SEK per cubic metre).

To explain the “gap” in the price trends for forestland and forest products, we must look at soft factors or search for systemic changes. The first category includes recreational and status value. The second includes the growing demand among financial investors for stable, predictable returns. We can also see that the deregulation of the Swedish credit market that occurred in the mid-1980s expanded the supply of investable capital.

In addition, we should take into account a “new” forest product – biomass – and its rising value. There are no lengthy time series showing the price trend, since this commodity was previously never processed industrially. Perhaps biomass has a greater influence on the forestland price trend than we once believed. For example, data from the Swedish Energy Agency show that the share of wood-based fuels in the mix of materials burned at Swedish district heating plants increased from 0.87 per cent in 1980 to 38.7 per cent in 2007.

FOREST COMMODITIES VS FORESTLAND



The chart above and the table below illustrate the indexed price trend for Swedish forestland, timber and pulp wood on a logarithmic scale. During the first 20 years, the curves flowed with each other. After that the correlation decreased.

		Forest-land	Timber	Pulp wood
Correlation	Forest-land	1		
	Timber	0.127	1	
	Pulp wood	0.081	0.592	1

Avg annual return (%)		10.1	5.9	5.6
Standard deviation*, %		18.0	15.2	13.7

*Calculated using annual data, 40 measuring points

In recent years the price trend for Swedish forestland has continued upward, although some slowdown and regional differences have been discernible. Is it possible to identify the characteristics of forestland as an investment, though at lower initial levels than in Sweden?

The fact that timber, pulp wood and biomass are traded in both US dollars and euros in the international arena makes it worth the trouble to search. Potential investors may benefit from studying opportunities in the countries around the Baltic Sea, where the types of trees and soil conditions are similar to those in Sweden. There is heavy demand from Nordic processing plants for forest products from all of the Baltic countries. In 2009 Sweden imported more than SEK 4 billion worth of forest products from across the Baltic Sea, making Sweden the fourth largest importer after Finland, Germany and Norway.

Baltic countries resemble Sweden

With soil qualities similar to southern Sweden, forestland prices in Latvia, for example, are 25-50 per cent below those in Sweden. As an investment, forestland in the Baltic countries can thus be considered very attractive, knowing it can be managed using the same methods and types of trees as in Sweden. Based on this argument, we expect either an increase in the value of forestland in the Baltics or a slower price increase for Swedish forestland.

One additional factor that favours investing in forestland in a larger context is the global energy situation and the debate on sustainable energy sources. There are clear incentives for greater use of alternative energy sources, with biomass playing a key role. In global energy policy, there are important targets for replacing fossil fuels with renewable ones. Forest products will inevitably attract more and more attention, especially those that have historically been left on the land after felling and thinning trees. More and more biomass is being produced from felling waste. Nor is there any major difference between countries in this context globally, as long as the forestland is used in such a way that a local factory can process several product categories.

Given a steady decrease in global forest area and a growing population, forestland provides a good investment opportunity: an investment with high returns that reduces total risk in a portfolio. Meanwhile it is a green investment that provides another kind of satisfaction as well.

A number of Swedish professional investors have already discovered the potential in other countries around the Baltic Sea. In Latvia, for example, Swedish investors constitute a sizeable group of forestland owners.

2012 – undramatic off-year for companies

- *A mild dip followed by new expansion*
- *Companies well positioned for the future*
- *Large relative potential for cyclical sectors*

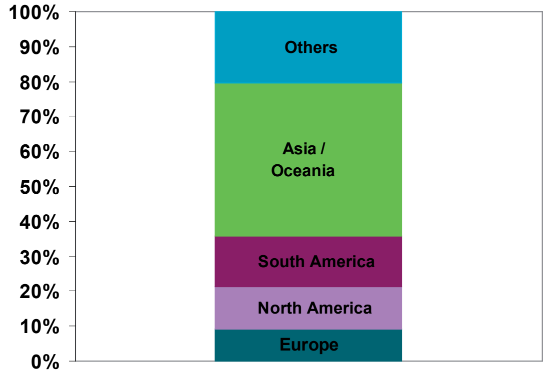
Profits for Nordic listed companies are expected to grow by almost 5 per cent in 2012. Earnings for companies on the Nasdaq OMX Stockholm exchange should fall by almost 6 per cent, but record profits are expected in Copenhagen and Oslo, while Nokia will weigh down the Helsinki exchange. As a result, 2012 return on equity for companies in Sweden will be 14.0 per cent in Sweden, compared to an average of 15.6 per cent in the past 10 years. The corresponding figures for the other Nordic countries are 12.7 and 14.6 per cent respectively. Thanks to a slightly more favourable macroeconomic situation, return on equity is expected to improve as early as 2013 to a fairly normal 14.8 per cent in Sweden and 13.8 per cent in the other Nordic countries. However, market valuations are about 20 per cent below the 10-year average, indicating the market has already discounted significantly lower growth in profits going forward than is in line with our macroeconomic forecasts.

First-quarter reports confirm that the year began basically as expected. Of the 94 large- and mid-cap companies on the OMX Stockholm exchange that had issued reports prior to this publication going to press, 46 reported better than expected earnings and 30 reported worse than expected earnings. At an aggregate level, profits were 5 per cent above our forecast and down 4 per cent compared to the same period of 2011. The greatest upside surprises were industrials and banks. Industrials also foresee unchanged or slightly better market conditions in the immediate future. In the past month, we have adjusted our earnings forecast for 2012 upward by 8 per cent for banks and 4 per cent for industrials. These increases in projected earnings fully offset our lower earnings forecasts for telecom operators, forest products and retail.

Companies well positioned

We expect weak economic growth over the foreseeable future in Western countries, but urbanisation and industrialisation in emerging economies will continue. That is not a new development, but it still creates challenges for listed companies. Sales growth for industrial companies has long been driven by markets outside Europe and North America. The eight largest industrials on the OMX Stockholm exchange, which together account for half the market capitalisation of the OMXS30, have generated about 80 per cent of their sales growth in markets outside Europe and North America since 1999. Asia (including Oceania) alone accounts for a full 44 per cent of sales growth.

EMERGING MARKETS BEHIND CORPORATE SALES INCREASE



Source: Annual reports of ABB, Ericsson, Alfa Laval, Atlas Copco, Sandvik, Scania, SKF and Volvo.

The chart shows where the growth came from by region in the years 1999-2011 for the eight largest industrials on the Nasdaq OMX Stockholm exchange.

In other words, it is critical to the growth of listed companies that emerging market economies continue to expand by 5-6 per cent annually. On the other hand, extremely weak growth in the euro zone is really not a new phenomenon that they need to adjust to.

Thanks to high growth in Asia, Latin America and Africa/the Middle East, exposure to these geographic areas today is twice as large as at the turn of the millennium.

The situation is similar for Finnish industrials, while oil makes the Oslo stock exchange dependent on expansion in the emerging economies. The Copenhagen stock exchange, with its large exposure to the health care sector, has a completely different profile.

Cyclical sectors nearing the bottom

The chart below shows an index of the relative price trend for Nordic listed companies divided into two groups of equities – cyclical and defensive. When cyclical equities perform better, the index climbs, but when defensive equities have the better price trend, the index falls.

The cyclical group includes industrial, IT, forest product, commodity and oil companies. The defensive group includes stable companies and those not sensitive to fluctuations in the economy, such as telecom operators, food processors and health care.

Over the past 20 years, cyclical and defensive equities on the Nordic exchanges have traded in a clear interval vis-à-vis one another. We are now once again nearing the bottom for prices of cyclical compared to defensive equities. The relative downside for cyclical equities is less than 10 per cent in the interval while the upside is equal to 50 per cent.

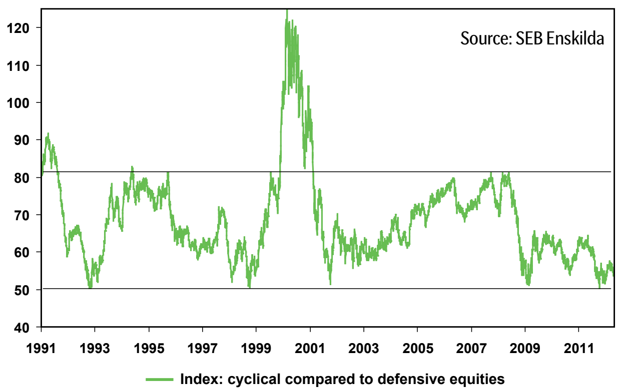
For natural reasons, cyclical equities tend to be relatively weaker in times of turmoil. For instance, clear lows can be seen in the chart in connection with the Nordic banking crisis in the early 1990s, the Asian financial crisis at the end of the same decade, just after the 9/11 terrorist attacks in 2001, and most recently after the Lehman Brothers collapse.

Since then, the index has fallen towards the bottom repeatedly in conjunction with mounting concern about the euro crisis.

During periods of sustained or escalating worries, investors tend to opt for stable, safe shares in companies with limited dependence on the general economic trend, preferably in combination with a high dividend yield which makes its attractive valuation apparent.

The above selection criteria are sensible, but the preference for these defensive equities has long been so strong that their relative potential for price appreciation appears limited. If our main scenario for economic growth in Europe this year and next plays out, investor preferences for defensive equities will decrease, at least compared to the current situation. Meanwhile, it is important to note that the relatively weak price trend for cyclicals is not related to weak growth in earnings. Industrials and banks stood out as upside surprises in first quarter reports, and the sectors with the highest profitability historically are industrials and commodities.

Safe and stable is still the favourite investor strategy, but be prepared for this to change quickly, with cyclicals then having great potential.



LARGE POTENTIAL AND LIMITED RELATIVE DOWNSIDE FOR CYCLICALS

The chart shows the index of cyclical equities compared to defensive equities. It is clear from this that compared to defensive equities, cyclical equities are currently trading at levels we have only experienced five times in the past 20 years. In other words, cyclicals should have an advantage once market worries have subsided.

Capitalism – the duality of profit and loss

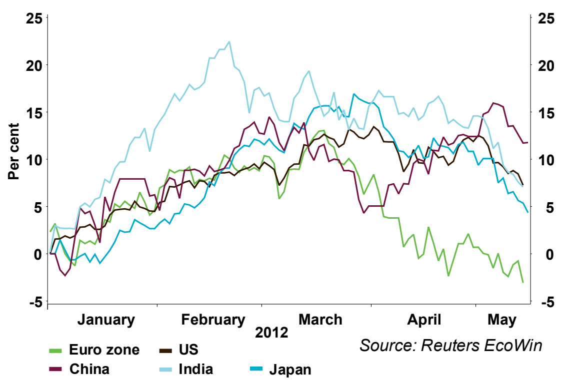
- *Banks are leading the markets, both on the up- and downswings*
- *We continue to favour exposure to emerging markets (BRICs) and the US rather than Europe*
- *We are somewhat concerned that equity markets have become addicted to fiscal stimulus*

After a very strong performance during the first quarter of this year, markets have entered a somewhat more consolidating phase. In the past few weeks, headwinds have mostly come from weaker economic data in both the US and China, coupled with rising bond yields in both Spain and Italy. The flow of "better than expected" figures from the US labour market has stalled (hopefully temporarily), while China saw the Markit/HSBC purchasing managers' index (PMI) falling below the 50 level – the threshold between growth and reversals) for the sixth consecutive month.

The world's stock markets began the year strongly, and some of the major exchanges have delivered positive returns so far. At times it has been a choppy ride and a continued case of "risk-on" and "risk-off". Year to date, however, the US and China have performed best, gaining 7-8 per cent, while several developed markets have risen about 5 per cent. Not unexpectedly, the biggest laggard has been Europe, with declines of about 2 per cent so far this year (in local currencies). But the picture for Europe is one of mixed performance, with Germany being the largest gainer. We find most of the losers in southern Europe, of course, where stock markets have generally delivered a negative performance. As indicated in the last *Investment Outlook* (published February 21, 2012) we expect the euro zone to continue struggling with challenges related to austerity measures and the lack of growth prospects. This very much remains our hypothesis.

We still believe that both the US and emerging markets will continue to offer attractive investment opportunities for investors that are able and willing to weather periods of increased volatility (greater price fluctuations). Looking at sector performance in Europe, it is worth noting that the banking and financial sector is now leading the market both on the up- and downswings. The fact that this is a highly leveraged sector will of course increase its market beta (price movements as a consequence of market movements). Adding to this is the close link between sovereign debt and bank balance sheets. Through the European Central Bank's LTRO programme (three year loans at 1 per cent interest), euro zone banks have increased their exposure to sovereign debt (financing bond purchases at 6 per cent yields with a 1 per cent funding cost seems like a good investment) and are hence more vulnerable to periods of increased volatility in the euro zone debt market.

EURO ZONE DEBT CRISIS LEAVES ITS MARK



The worst stock market performance so far during 2012 is in the euro zone, where prices have fallen a few per cent. Other markets are up 5-8 per cent. But in the euro zone, performance varies sharply: share prices in Germany are up around 7 per cent, while in Spain they have fallen about 22 per cent.

Valuations well below historical averages

Valuations in most markets are well below their historical pricing both in terms of price/earnings and price/book value ratios. This is especially true for the euro zone, but the BRICs are also trading at discounted levels to average historic pricing. Among the BRICs, the Russian stock market stands out as the cheapest measured using the above multiples, but this has been the case since before the financial crisis of 2008.

The strong performance of the S&P 500 has lifted US equities to levels approaching their historical average, currently at P/E 13 and P/B 2.1. Important to note is that although we by no means expect future earnings to drop, current earnings estimates are based on profits margins close to the record levels seen in 2007. These high margins are a consequence of fierce cost cutting in the aftermath of the financial crisis, combined with technological advances, lower corporate tax rates and low funding costs, and are not likely to rise dramatically from current levels.

Changes in estimates for earnings in the S&P 500 index have only been slightly negative over the past 12 months, while estimates for European earnings have come down substantially during the same period. The implied growth expectations in the earnings estimates for 2012 and 2013 are, however, not that different between the two markets (8 and 14 per cent for European equities, 10 and 13 per cent for US equities) indicating that although European equities are priced at a cheaper multiple than their US counterparts, investors are currently betting on growth rates in both markets developing fairly similar.

We believe that the sovereign debt crisis will continue to create major challenges for European equities and remain true to our previous strategy of favouring US and emerging market equity exposure as opposed to European.

Worrisome addiction to stimulus

In the coming years, global equity markets will reach some sort of threshold from which we will again experience good returns as a consequence of long and stable economic growth. We are firm believers in capitalism and its ability to create economic growth. However, with capitalism also comes the notion of loss. Capitalism is based on the duality of both upside and downside, profit and loss. You cannot have one without the other.

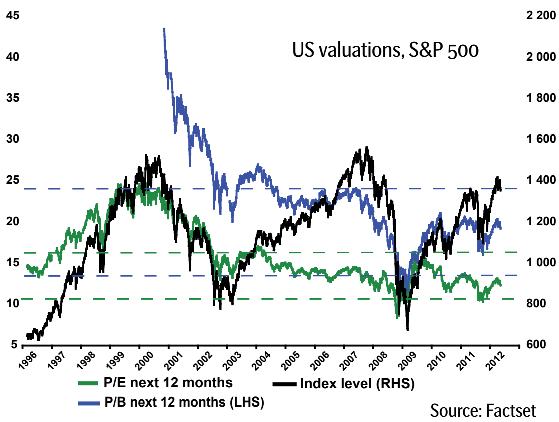
Massive deleveraging high on the agenda

Economic loss is not a problem for society if it is limited to a particular individual. It may be a challenge if it is related to single companies. Where economic loss becomes a major problem is when it is related to entire sectors or even countries, which over the years have become economically too big to fail. This is the current situation in parts of Europe. While the US has recapitalised its financial sector (the federal budget still remains to be dealt with, hence last year's downgrade from the AAA rating), European problem countries and their respective financial sectors currently face massive debt deleveraging. These entities, whether they are individual countries or large banks, will at some point need to face losses and will need to be recapitalised. Looking at the amounts of stimulus being fed into both European economies and the financial markets, be it by the IMF, wealthy sovereign states or the ECB through its LTRO programme, it is obvious that political leaders are doing everything in their power to avoid a negative market trend.

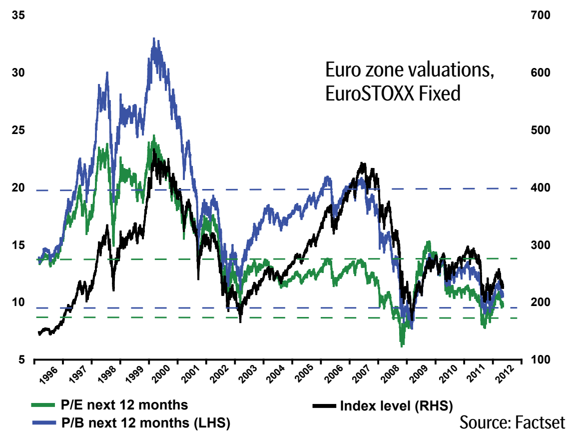
The aim of this huge amount of economic stimulus is, of course, to make the transition from a contracting economy to an expanding economy as smooth as possible. Somehow this always seems to be the "main scenario" or "base case" for economists. Let's hope they are right.

From a portfolio manager's perspective, however – trying to balance risks and rewards optimally – there is reason to adopt a cautious attitude in the coming months. Speculation related to structural refinancing of both countries and financial institutions is not to be neglected. We therefore remain cautious towards this asset class. Capital preservation will never become outdated.

EUROPEAN VALUATIONS AT HISTORICAL LOWS



Source: Factset



Source: Factset

American equities have performed relatively strongly in the past year, leading to company valuations that are currently at levels around their historical average. Euro zone companies, however, are trading at well below their historical average in terms of P/E and P/B ratio, which is a consequence of significantly poorer stock market performance in the region.

Central banks accumulating low-octane securities

- *Yields on short-term government securities will remain low for a long time...*
- *... while government bond yields will rise – for several reasons*
- *High yield bonds and EM debt still the best alternatives for fixed-income investors*

Most analysts and financial market players agree that the leading central banks in the OECD industrialised countries – the US Federal Reserve, the European Central Bank (ECB), the Bank of England (BoE) and the Bank of Japan (BoJ) – will maintain their "zero-interest rate policy" for at least a few more years. In the US, even the Federal Open Market Committee (FOMC) concurs with this forecast, "promising" to keep interest rates unchanged at 0-0.25 per cent at least until the autumn of 2014.

As for "unconventional" monetary policy measures – mainly government bond purchases – the future scenario is not as clear. In hindsight, such measures in recent years have led to a veritable explosion in the balance sheets of the major central banks, with a ballooning of assets through government bond purchases and growth in liabilities reflecting the financial system's increasing claims on the central banks. This rise in debt is equivalent to an expansion in the monetary base (paper money, coins, banks' reserves with the central bank).

However, in order for the money supply in an economy to grow, commercial banks need to use their reserves with the central bank as a basis for lending to households and companies for consumption and investment. That would get the credit multiplier rolling. Only then would unconventional monetary policy measures deliver their full stimulatory effect to the economy.

Thus far, the bond purchase policy has mainly benefited the economy through significantly lower government bond yields than would otherwise have been the case. Central banks thus have a direct impact not just on the shortest-term yields – which is "normal" – but all along the yield curve, which is created by charting the yields on securities with different maturities. In Europe the ECB's two three year loans to banks totalling EUR 1 trillion (gross) – in addition to reducing the risk of acute financing problems in the banking system – have also helped lower bond yields as banks have, among other things, purchased government bonds from their own country with money borrowed from the ECB.

While the money supply in the euro zone has increased only marginally over the past year or so, the money supply in the US is growing at an ever faster rate. The Fed's unconventional policy is thus beginning to have broader positive effects on the economy. Another sign of this was provided by the Fed's most recent quarterly Senior Loan Officer Opinion Survey, which indicated that banks have eased their lending terms, while demand for both consumer and corporate loans is growing on a broad front across the country.

The message in the minutes from the Fed's most recent FOMC meeting in March also decreased the likelihood of new stimulus measures through bond purchases, at least in the immediate future. In March only a few FOMC members thought that new stimulus measures might be necessary if the economy loses momentum and/or inflation gets stuck below 2 per cent.

However, an unexpectedly weak labour market combined with persistently low inflation expectations and prospects of a far more austere financial policy after the US presidential election in November could lead to the question of new stimulus measures being put back on the agenda.

During the spring, the ECB has not signalled any changes in its monetary policy, even though there has been an obvious risk of recession in the currency union and concerns about Spain's finances have escalated. The ECB president, Mario Draghi, has instead reiterated that it is now up to crisis-plagued countries themselves to resolve their government finance problems and that the ECB needs time to study the long-term effects of the three year loans. A re-launch of the ECB's Securities Market Programme (SMP), which involves the purchase of government debt in secondary markets, does not seem likely at present. The refi rate has remained at 1 per cent since it was last lowered late in 2011 and we expect it to remain at that level over the next couple of years.

The ECB's actions are dominated by a fear that political leaders will ease up on the pace of austerity and reforms, but the question is how long the ECB can stick to this position. The positive effects of the three year loans are waning, and bank lending once again runs the risk of weakening. If Spain's problems escalate, perhaps in tandem with growing concern about Italy's finances, the ECB may possibly resume its bond purchases in the secondary market.

In the UK, inflation has long exceeded the BoE's 2 per cent target. But even if the rate of price increases falls below that target in 2013, any further stimulus plans is likely to remain on the shelf, judging from the minutes of the bank's Monetary Policy Committee meeting in April. In that case, the BoE will not increase its level of government bond purchases from the current GBP 325 billion, and the key interest rate will remain at 0.50 per cent at least until early 2014.

The Bank of Japan has made large purchases of securities (treasury bills and bonds, but also corporate bonds and ETFs), and in early May announced it would expand such purchases by JPY 5 trillion to JPY 70 trillion as its target for next summer. Given the prospects of continued deflation (generally falling prices), the large amount of slack in the economy and severely strained government finances, further monetary easing cannot be ruled out. Japan's key interest rate is generally expected to remain around 0.10 per cent for many years.

The central banks have accumulated large quantities of government bonds issued by heavily indebted borrowers, which has helped reduce the attractiveness of these instruments to fixed income investors. In particular, as a result of Fed bond purchases, yields on US government securities on all maturities up to 30 years are lower than inflation; in other words, real interest rates are negative. This is in sharp contrast to the early 1980s. Back then, the yield on US Treasury bills was 7-8 per cent in real terms, while the real yield on 10-year US Treasury notes at its peak was 10 per cent.

In light of all this, it is difficult to see any other direction than up for government bond yields in the US – and in the core countries of Europe – over the next few years. Other factors to consider are the reluctance of some central banks to continue their bond purchases to support prices (see above), the great need for bond issues and the prospects of decent risk appetite, which has usually not favoured government bonds.

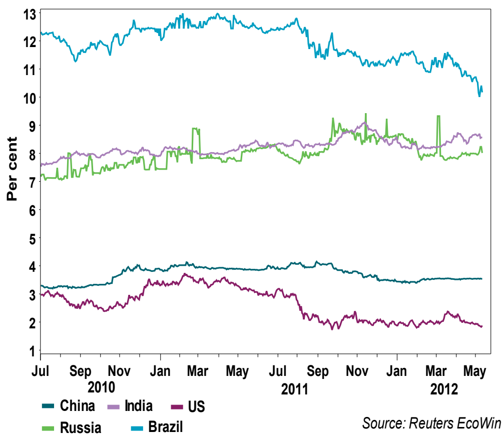
Greater potential returns

As an alternative, corporate bonds – especially high yield – and emerging market bonds (EM debt) offer fixed income investors far greater potential returns than government bonds in OECD countries.

In many ways, the financial situation of companies is better than that of many OECD countries. The reporting period just ended was dominated by surprisingly larger profits and high sales, among other results, while companies have strengthened their balance sheets in recent years through reduced debt, longer maturities on bond loans and increased liquidity.

Furthermore, the percentage of bankruptcies among high yield companies globally in March was only 2.3 per cent, calculated over a twelve-month period, and the credit rating agency Moody's forecast for December 2012 is 3 per cent, compared to an average of 5 per cent since 1983. The current yield gap between corporate and government bonds also indicates that the market is factoring in a significantly higher bankruptcy rate than is likely.

There is thus room for a shrinking yield gap and lower corporate bond yields, with accompanying potential price gains for fixed income investors.



Source: Reuters EcoWin

YIELD GAP SUGGESTS GOOD INVESTMENT ALTERNATIVE

Yields on 10-year government bonds in the BRIC countries – Brazil, Russia, India and China – are significantly higher than yields on similar US treasuries, even though public sector budget deficits and current account balances are far better in the BRIC countries – with the exception of India – than in the US. This along with the prospect of interest rate cuts and stronger currencies are arguments for buying bonds issued by the BRICs and other EM countries.

Market situation favours defensive managers

- *Political uncertainty is shaking hedge funds*
- *Managers are trying to be faster on their feet*
- *Imbalances between and within asset classes point toward Relative Value*

Hedge funds had a good start to the year, but the trend since the last issue of *Investment Outlook* (published February 21, 2012) has levelled off to some extent. Some of the strategies that suffered most in 2011 were the ones that fared best during the first quarter. The swings between "risk on" and "risk off" were less severe as volatility and correlations decreased. The HFRX Global Hedge Fund Index (in EUR) ended the quarter up 3.1 per cent, with most of this rise coming through the end of February. Risk assets were bolstered by a combination of improved macroeconomic indicators, reduced fear of a euro zone collapse and very favourable monetary conditions. It was not a complete surprise that the strategies with the highest market exposure performed best.

Prospects for the near term have become slightly more mixed. On the negative front, we have the euro zone spectre haunting the scene once again, this time with the focus on Spain. The French presidential election created some uncertainty, and the US recovery may be weaker than previously hoped. On the positive front, more and more observers are ruling out a hard landing for China, while another positive factor is that there is now actually a structure in place for the euro zone to put out "fires". Still, there is renewed concern about mounting political uncertainty, which could give rise to choppiness in the market and make it difficult to generate revenue over the next few months.

As in previous issues of *Investment Outlook*, we have chosen 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

The first quarter of 2012 was the best for this strategy since the third quarter of 2009. The sharp upturn in the stock markets was driven by macroeconomic factors and liquidity. US and German statistics showed upside surprises while the European Central Bank's Long-Term Refinancing Operation (LTRO) produced a surfeit of liquidity, eliminating the risk of panic-induced liquidity stress among euro zone banks.

In this kind of environment, managers with a high net exposure to equities post by far the best performances. For the same reasons, hedge funds that performed worst last year have been those with the best performances this year and vice versa. Most L/S managers tend to have a bottom-up focus, but it is hard to argue that company fundamentals have been a major driver here. Performance has instead been driven by broader market exposure rather than solely by equity picks. In our main Equity Long/Short strategy, Long Biased and Variable Net have shown the strongest performance. Except for a few managers, Market Neutral has had a tough time, which led to a decline of 1.6 per cent for HFRX Equity Market Neutral during the quarter.

After a strong start to the year, US macroeconomic data such as the purchasing managers' index and labour market statistics have recently shown weaknesses. Despite the LTRO effects, there is once again mounting concern in Europe, this time with the focus on Spain. Election results in France (with its new president, François Hollande) and Greece (where a total of nine parties exceeded the three per cent threshold to enter parliament) will most likely lead to greater uncertainty in the coming months. Managers with a real ability to generate returns by going either long or short will fare better than those who are more dependent on the direction of the market in general. Equity Market Neutral will probably be resilient over the coming period, which will be slightly more uncertain. In a stock market rally, it would not perform all that well, but on the whole it would be able to contribute a positive return with extremely low risk.

Relative Value

Interest-bearing strategies performed well in general during the first quarter, with HFRX Relative Value closing up 3.56 per cent. The environment of continuing low short-term interest rates in mature markets caused managers to instead focus on long- and medium-term maturities. They were also forced to be more tactical given the risk of a rally during the quarter. Passive and long positions which worked well in 2011 would have been painful during the quarter, especially those focused on the US. Credit spreads continued to fall, bottoming out sometime in mid-March; they have risen since then but have not come close to the levels we saw around the turn of the year. Some of the managers with top results in 2011 were doubtful about continued growth and thought the liquidity injections would have a more temporary effect. This view was not particularly favourable during most of the quarter but began to pay off in the latter part as storm clouds began gathering again in the euro zone. Still, the fact remains that LTRO has stabilised concern about European government bond issues. Moreover, there was no panic over bank lending, as many had expected. The Greek debt restructuring was largely well received by the markets. The liquidity situation improved significantly, and corporate bond managers have been more willing to selectively increase their exposure, thanks to clearer growth differences between various regions and sectors.

As for the US, managers have focused on understanding and trying to predict the implications of any changes in central bank key interest rates. While there was very strong support for low interest rate policy a few months ago, there has been some doubt about quantitative easing at the Fed, which will increase uncertainty about the medium- and long-term portion of the yield curve. Managers will probably remain tactical going forward. We continue to be positive about Relative Value although we suspect more cautious managers will post the best performances.

Event Driven and Distressed

Event Driven strategies rose sharply during the quarter. HFRX Event Driven and HFRX Distressed were up 5.8 per cent while HFRX Merger Arbitrage increased 1.7 per cent during the same period. A major factor contributing to the positive trend in Merger Arbitrage was narrowing spreads as mergers and acquisitions approached their closing date and were de facto completed. Investments driven by fundamentals and valuations in both equities and corporate bonds were favoured by the risk rally. Managers who were able to hold onto investments they made during the second half of last year reaped considerable gains. While many are pleased with the liquidity stimulus in Europe, there is some scepticism about the sustainability of the situation. The low interest rate environment presents opportunities for some more complex forms of arbitrage. Managers are hopeful that companies will finally begin to use their balance sheets and get involved in acquisitions. The general view is that this will occur, but 2011 created a great deal of uncertainty about this. Distressed strategies were favoured primarily by the risk rally at the start of the quarter. Managers have continued their hunt for new situations and have focused on profit-taking and optimising their portfolios for the rest of the year. There was some hope of slightly more extensive sell-offs by European banks, but activity has been limited.

Macro and Trading

There were rather large differences for individual managers, but HFRX Macro/CTA fell as a whole by 1.3 per cent during the quarter. The LTRO programme eased liquidity pressure at the end of 2011 but caused the markets to almost overflow in early 2012. Market players were more optimistic about the US economy after that, and we had a risk rally. Downgrades in Europe led some managers to review their positions, and in the end those who maintained their risk positions were the ones with the most success. The euro rose rather unexpectedly in February, and US 10-year note yields were choppy in March, which led to rather subdued results for the last two months.

CTA and Systematic Macro began the quarter rather mixed as a result of allocations and timing decisions. Profits were generally driven by bond and commodity holdings. Earnings from equities were weak, while currencies were fairly mixed. The sharp swing in bonds together with the euro's recovery caused significant losses for many managers positioned for the opposite situation.

Our long-term view is that CTA and Systematic Macro belong in portfolios both as an absolute return and a diversified holding. Still, our slightly shorter-term assessment is that this strategy is vulnerable in an environment where investors have a "risk on/risk off" attitude. We should be prepared for a weaker period before the strategy can once again provide the same kind of protection as in 2008, for instance. We now have a more neutral attitude and believe a reduction in positions may be justified.

STRATEGY	INDEX	CHANGE % (USD)			
		April 2012	Q1 2012	2011	2010
Global Hedge	HFRX Global Hedge Fund	0.12	3.14	-8.87	5.19
Equity Hedge	HFRX Equity Hedge	-0.09	3.94	-19.08	8.92
Relative Value	HFRX Relative Value Arbitrage	0.28	3.56	-4.00	7.65
Event Driven	HFRX Event Driven	-0.10	5.81	-4.90	1.98
Macro	HFRX Macro	0.43	-1.29	-4.88	-1.73

Source: SEB

Weaker activity at the start of 2012

- *Clear drop in European activity weighing down the market*
- *Declining correlations promise a better invest ment climate*
- *The REIT market is attractive, but not for those without risk appetite*

In recent years, the world real estate market has mainly been characterised by increased demand for properties in the larger, more liquid and less risky primary markets. One driver behind this demand has been the search for substitutes for a government bond market with extremely low yields. Another reason has been the unusually jittery investment climate that has prevailed in this period. The global economy is still showing weakness in the form of a euro zone sovereign debt crisis, more stringent lending terms and persistent uncertainty about economic prospects. However, some recent positive signs are stabilising expectations about the economy and a gradual improvement in the global financial system. Primary markets are still capturing the greatest investor interest, but with such strong demand and a limited supply of quality properties, interest in secondary markets has also picked up somewhat over the past six months.

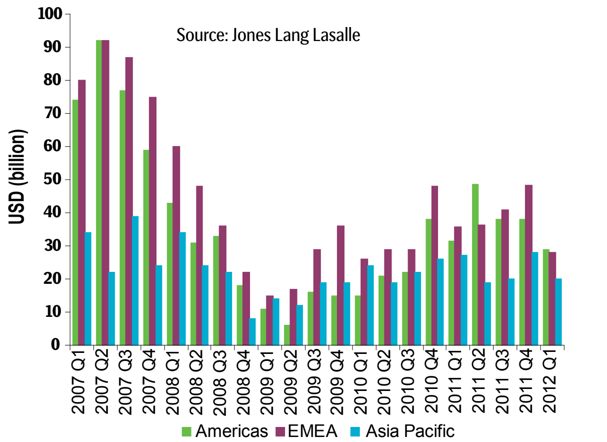
Decline in global activity after a strong 2011

Sales activity in the global commercial real estate market was strong in 2011, with the last quarter being the most active, even though the debt crisis in Europe reached its peak during the same period. However, weaker activity was recorded in the first quarter of 2012, both on a quarterly and year-on-year basis.

The sharpest decline in transaction activity was seen in Europe. Meanwhile, activity in the leasing market slowed during the first quarter of the year. Rent and return levels stabilised during the end of 2011, a trend that seemed to continue in early 2012 as well. While property markets in parts of Europe (including Germany, Poland and the Nordic countries) are considered "safe havens", the market in peripheral countries is still weighed down by the lingering debt crisis.

The US, which ended 2011 with its highest sales volumes since 2007, posted lower activity on a quarterly basis during the first quarter of 2012. However, on a year-on-year basis, activity was in line with 2011. Leasing activity fell further at the start of 2012, while the supply of leasing space fell. With the slow pace in the American construction industry continuing while leasing activity absorbs available space, the falling trend in vacancies should continue. Rent levels as a whole barely budged in the first quarter of 2012, and in most markets rents have now bottomed out.

TRANSACTION ACTIVITY IN EUROPE HAS FALLEN SHARPLY



During the first quarter of 2012, weaker activity was recorded on both a quarterly and year-on-year basis. The sharpest drop in sales activity was seen in Europe as a result of more stringent lending terms and continued uncertainty about economic prospects.

Asia also saw a decrease in activity, although transaction volumes are still at relatively high levels in historical terms. Leasing activity in the region is mixed, with China still showing a fairly high level of activity, but Hong Kong and Singapore are showing some slowdown tendencies. Changes in rent levels also seem to diverge widely in the region, with rising rents noted in China, South Korea and elsewhere while Hong Kong and Singapore are reporting falling rent levels. While the trend for the region is mixed at present, Asia's demographics and income growth are expected to bolster the property market there in the long term.

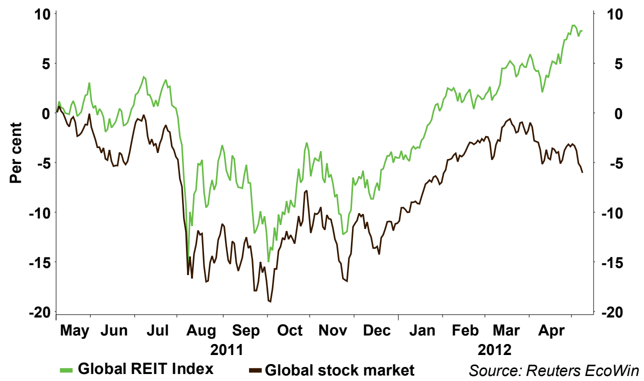
A healthier investment climate

In 2012, different risk assets have found their way back to more favourable correlations after the extremely high co-variation we saw in the autumn of 2011. This could be interpreted to mean that investors have eased up on some of the risk on/risk off thinking that dominated the market last autumn and winter, which is usually the reason risk assets move in much the same direction. During the spring, investors instead seem to have returned to focusing more on underlying conditions for different types of assets. In this way, a much healthier climate from a risk-adjusted return perspective has been created.

Investments in the indirect property market (real estate investment trusts, or REITs, and listed shares of real estate companies) also correlated strongly (about 95 per cent) with global equities during the second half of 2011. However, in 2012, this correlation fell to about 80 per cent, with the performance of the different assets also showing some divergence recently.

On the sidelines of the property market

Since last summer, real estate has been an asset class that we have taken a fairly cautious approach to. Illiquid investments in the direct property market were not attractive during the shaky autumn, and interest in more volatile indirect property investments via REITs and shares in property companies has dwindled. While our outlook on this asset class has not been negative, we have still chosen to remain on the sidelines for a while. However, if the global economy continues to strengthen and as we see further signs of a healthier financial system, it may soon be time to resume a position in real estate.



FADING CORRELATION WITH THE STOCK MARKET

The extremely strong correlation that the REIT market showed with the global stock market in the second half of 2011 gradually weakened in 2012. Recently, we have also seen a clearer disparity between price trends for these asset classes.

To be(ta) or not to be(ta)?

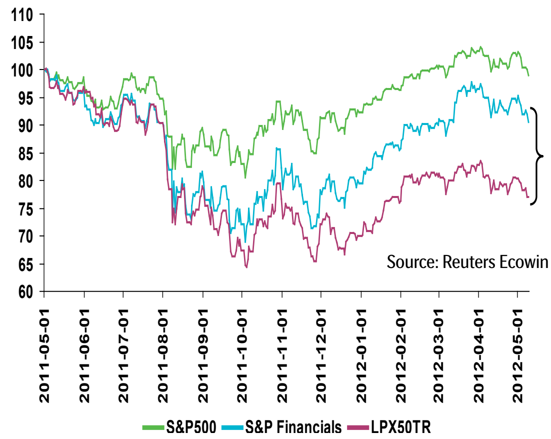
- *Underlying portfolio companies generally performing well, with persistent discounts to NAV*
- *Unstable financing environment and economic situation contribute to greater de-coupling*
- *Alpha-generating ability is probably the most important key to success in the near future*

Investors generally tend to see private equity (PE), especially listed companies, as a high beta version of equities or as an investment in financial shares. At first glance, the recent trend is no exception. In the past few years, the index for listed PE companies has moved more, both up and down, than the broad stock market and roughly in line with companies in the financial sector. However, since the stock market plunge in early autumn 2011, a partly new pattern could be discerned. During the autumn, PE companies followed the financial index all the way down but have not recovered to the same extent. In the last issue of *Investment Outlook* (published February 21, 2012), we argued that this trend was unjustified. The situation persists to a certain degree, but we also see other, more long-term factors behind the greater de-coupling between PE companies and financial shares. This time, we are highlighting these factors.

If we first assess the general situation, we note that the PE sector has done quite well recently from a fundamental perspective. The underlying portfolio companies are still performing well in general, and net asset values (NAVs) are now holding up well (after the downturn triggered by the stock market plunge). The financial position of the companies is also still stable, and their leverage ratio has continued to fall slightly while debt durations have been extended significantly in the wake of the financial crisis.

On the other hand, we foresee an unstable financing situation in which the desire and ability of banks to lend money are subject to pressure, which is troubling since the financing market is essential for PE companies. Persistent uncertainty about economic growth also adds to uncertainty about the sector's ability to generate returns going forward.

WEAKER RECOVERY THAN THE FINANCIAL SECTOR



The broad index for listed PE companies (maroon curve) has not recovered as strongly as the financial sector (turquoise curve). This may be a sign of a greater de-coupling from a historically clear beta adjustment.

If we look at capital flows and liquidity, this too is a divided picture. Clearly, transactions in the PE market have declined significantly. During the first quarter of the year, some 300 deals were closed globally, compared to almost 500 for the preceding quarter and about 400 during the same quarter of 2011. Long-term reductions in transaction flows tend to have a negative impact on the desire to invest in this sector since they limit the opportunities for companies to make good investments in a weak exit market. Still, investor interest in PE has actually increased on the whole, which has helped bring a fairly large inflow of capital to the sector. Combined with the fact that many PE companies have not found any investment objects for the capital they raised in the market earlier, this creates clear investment pressure. Meanwhile, we know that a number of players, particularly European banks, need to sell their PE investments for financial or legal reasons.

As a result of the factors described above, listed PE companies have continued to trade at historically high NAV discounts, around 35-40 per cent. However, high discounts, together with the weak price trend recently relative to the financial sector, bode well for the potential of PE companies going forward.

But even though there is potential, we also see a number of differences in PE conditions which may justify greater decoupling from the general market trend, and perhaps also a generally lower valuation than the historical average.

The factors that have recently changed most are:
- The strength and pattern of economic growth
- Instability in the lending environment
- The difficulty of assessing the flow situation

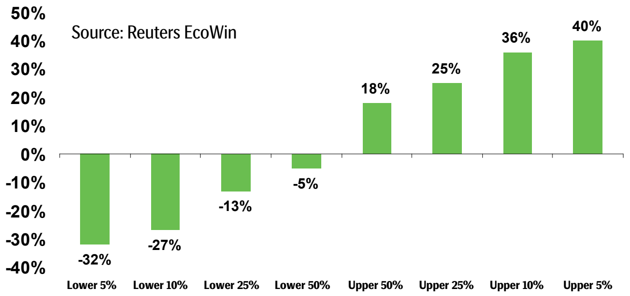
As for the state of the economy, we foresee a period with clearly slower growth, mainly in the industrialised countries, which will hamper global growth. We also argued earlier that this growth will be more volatile or "wobbly" than historically. In an environment dominated by uncertain growth, the difficulties of forecasting the sales trend (top line) and the risk of disappointment in terms of ability to generate returns (bottom line) increases. Greater uncertainty about company earnings may result in a generally more prudent valuation of shares, which hits the PE sector especially hard given its leveraging. Combined with increased uncertainty about financing and capital flows in the market, this points towards a lower valuation than the historical average.

Although the above factors make it difficult to assess the situation, the picture is not entirely gloomy. First, there is potential for stabilisation going forward both in terms of economic growth and the health of the financial sector. Second, the situation is already sufficiently stable to generate good returns for PE players able to take advantage of opportunities to attract capital and create real added value in their portfolio companies.

In a market where growth is not a given, the choice of managers is especially important. Studies also indicate that there are major differences between the ability of PE managers to generate excess return, alpha. A study from Golding Capital Partners compares PE managers' ability to create excess return during the period 1977-2010 with a comparable share index (refers to managers in the US and Europe and includes 4,200 transactions). The study shows that the upper half generated an alpha of 18 per cent while the lower half created a negative alpha of 5 per cent. It is also noteworthy that the most successful five per cent of managers are able to create an alpha of 40 per cent relative to equities. Other studies also confirm this view of major differences in the ability of PE managers to create excess returns over time.

In a world dominated by macroeconomic and financial risks, private equity companies will be increasingly unable to rely on fundamental factors like growth and credit availability. Moreover, with ever stiffening competition for attractive investment prospects, alpha-generating factors such as the proactive search for investment prospects and value-creating ownership will be keys to success. Increased uncertainty and a scenario of slower growth clearly suggest it is no longer "enough" to buy an average PE portfolio in the hope that leveraging and underlying growth will create value growth that justifies the risk.

The low valuation in historical terms combined with the prospects of gradual economic stabilisation will create conditions for a relatively good performance for private equity over the long term. Nonetheless, great uncertainties today will lead to a wait-and-see approach to PE in general. The ability to generate alpha will assume ever more importance and is probably the critical key to success in the immediate future.



SHIFT IN ALPHA-GENERATING ABILITY OF PRIVATE EQUITY COMPANIES

A study from Golding Capital Partners compares PE managers' ability to create excess returns during the period 1977-2010 with a comparable share index (refers to managers in the US and Europe and includes 4,200 transactions).

Higher commodity prices towards year-end

- *Upside risk for oil prices in the near future*
- *Less speculation and many mining projects mean greater uncertainty for gold*
- *Normal weather and large stocks pushing down agri*

Since the last issue of *Investment Outlook* (published February 21, 2012), prices of industrial metals, agricultural commodities and gold have fallen a bit. Oil prices, in contrast, are higher today than three months ago, although prices at this writing are lower than their peak levels in March. Some of the underlying causes are weaker than expected macroeconomic statistics and renewed uncertainty about Chinese economic growth.

Mainly upside risk for oil prices

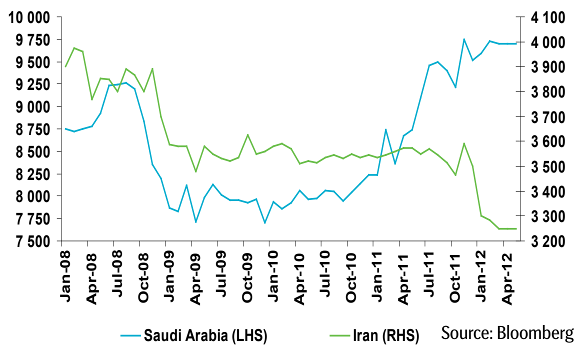
The price of oil (Brent crude) continued to rise in February, trading for most of March at around USD 125 a barrel. However, in April the price rise was dampened by a number of factors – weaker demand (in seasonal terms, the period between the heating season and the driving season), maintenance work at refineries, a new round of negotiations with Iran, relatively weak macroeconomic statistics and high production by members of the Organisation of Petroleum Exporting Countries (OPEC), largely ignited by Saudi Arabia.

As we get closer to the driving season, and with refineries now having started to increase production, a number of these factors no longer have as large a negative impact. Saudi Arabia, backed to some extent by increased supply from Libya and Iraq, has tried to push the price of oil down towards USD 100 a barrel to prevent Iran from offsetting its decline in production with higher prices. Nonetheless, market players have used this oversupply to build up their reserves. Still, the expected boost in supply from Strategic Petroleum Reserves (SPR) in the OECD countries could temporarily lead to falling prices this summer. Meanwhile various oil supply disturbances persist, such as the troubles in Sudan, Syria and Yemen, as do distribution disruptions in the North Sea.

Many factors may still push up oil prices. We cannot yet cross Iran off our list of trouble spots. It is entirely possible that the country has only re-launched negotiations on its nuclear programme to win time, and the situation could quickly deteriorate once again.

Moreover, higher production in the OPEC countries, mainly Saudi Arabia, is worrying over the long term. If Saudi Arabia uses a growing share of its reserve capacity to offset the loss of Iran's supply while demand outside the OECD continues to rise, there is a risk that we will find ourselves at the end of the year, during an expected economic recovery, in a situation of low reserve capacity and low reserves which could potentially lead to sharp increases in oil prices. We expect higher oil prices towards the end of 2012, but with the risk of reversals along the way.

HIGHER OIL PRODUCTION IN SAUDI ARABIA



Source: Bloomberg

Higher production in Saudi Arabia offset the drop in Iran's oil production by a wide margin, which kept prices down. The chart shows oil production in thousands of barrels a day.

Bumpy but positive ride for industrial metals

After a strong start to the year, prices of industrial metals have been falling. As we noted in the last issue of *Investment Outlook*, the critical factor for prices is whether China's economy will have a soft or hard landing since that country accounts for about 40 per cent of global consumption. In recent months, macroeconomic indicators in China have been slightly weaker, and there is growing concern about a hard landing. This has had an impact on prices. Some industrial metals are now priced at marginal production cost. This is true mainly for nickel, but aluminium is also approaching this level.

The situation for copper is different. The market for this metal is fundamentally strained, since supply growth is nonexistent. One storm cloud on the copper horizon is the rising reserves in China, which may be a consequence of the country having bought more copper than it needed. However, in our view, the Chinese are instead taking the opportunity to increase their reserves when they consider prices attractive; there are historical examples of this. We still believe that China is headed for a soft landing, so we should expect higher prices for industrial metals during the year. Still, it will most likely be a bumpy ride in the short to medium term. The market has to be convinced that the Chinese economy is not headed for a hard landing before we see significantly higher prices, and for that to happen, stronger signals are probably needed.

Less speculation in gold recently

The price of gold, like equities, has been rising since early 2009, but since the end of last year the trend has instead been weakly downward. Meanwhile the share of speculative gold positions has declined since mid-year 2011 and has now reached levels we last saw in 2009. The prevailing macroeconomic climate – with high liquidity, low real interest rates and high systemic risk – should provide support for the price of gold, but the fact that it is not rising may signal that the long positive trend is coming to a close. Growing concern about inflation or surprising liquidity injections seem less likely at present, so increased systemic risk is probably needed to lift the price of gold to higher levels. In times when there are expectations of liquidity injections, gold prices have tended to rise more sharply than those of other precious metals such as silver, palladium and platinum. When expectations of faster growth drive the market climate, the reverse has been true. That has been the case since November last year. Gold stands out as strongly overrepresented in terms of new active mining projects. An increase in the gold supply has historically gone hand in hand with rising prices. However, with the supply continuing to grow, combined with stagnating or falling prices, it is wise to take a cautious approach to gold in the near future.

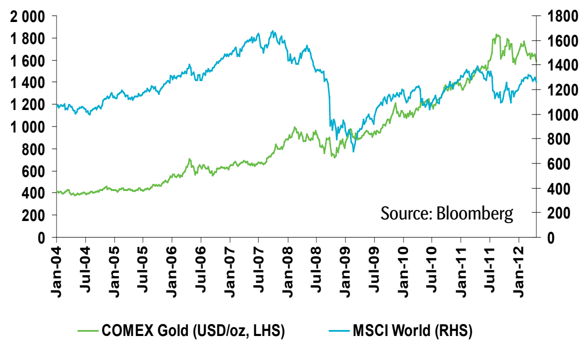
Recovery in agricultural prices is temporary

Agricultural commodity prices have been falling since spring 2011. However, most commodities recovered somewhat during the beginning of this year, which we believe is only a temporary break in the trend towards lower prices. However, soya beans are an exception, with the drought in South America bringing a severe supply disruption while demand from China is still strong. A number of factors point towards lower prices for other agricultural products. For some time, high prices have created an incentive to plant more, which should lead to larger harvests going forward. Furthermore, it is increasingly apparent that the La Niña weather phenomenon will give way to more normal conditions by summer.

Wheat is the grain showing the weakest fundamentals, in part because of large stocks, but also because the coming harvests are expected to be good. The price of maize (corn) may have a tough time rising in the near term since large harvests are expected while demand for ethanol production in the US has fallen considerably. Previously ethanol production accounted for about 40 per cent of maize demand in the US. However, earlier production subsidies and import duties on sugar-based ethanol from Brazil have been eliminated, which is pushing demand and thus maize prices down.

Given our main scenario, prices should rise

With the exception of agricultural commodities, the critical factor for commodity prices is the economic growth trend, especially in China. While recent US macroeconomic statistics have not always met expectations and statistics from China have led market players to once again question that country's economic growth, we are sticking to our main scenario that China will have a soft landing, the euro zone will not fall apart and global growth will continue at a reasonable pace. Assuming that our scenario plays out, prices of most commodities – and particularly industrial metals – have the potential to rise and to be higher towards the end of the year than today.



GOLD PRICES MORE DE-COUPLED FROM EQUITIES

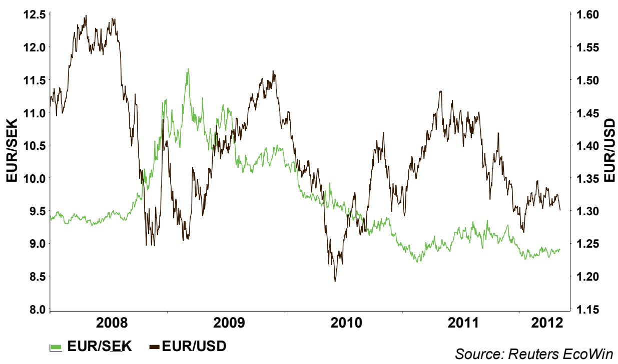
The strong correlation between the prices of gold and global equities since 2009 ended around mid-year 2011.

Currency movements conspicuously absent

- *Low level of activity in the FX market*
- *Dollar more attractive than euro*
- *Yen will eventually become cheaper*

Activity in the foreign exchange (FX) market has declined dramatically in recent months. Many currency pairs show few signs of life, and volatility (movements) has fallen significantly. One explanation is that, in times of weak growth, few countries want to see their currency appreciate, since a stronger currency hurts their competitiveness. At the same time, the currency market is a relative game. In order for one currency to strengthen, another one has to weaken, so most currency pairs are barely moving at all. For instance, Switzerland has chosen to introduce a floor of around CHF 1.20 per euro, with the Swiss franc not allowed to grow any stronger. The Japanese yen is another example, with the central bank intervening in the FX market to prevent the yen from rising excessively.

SMALL CURRENCY MOVEMENTS IN 2012



Most currency pairs have basically stood still in 2012. Thus far, acute problems in many euro zone countries have not had any major impact on the euro exchange rate.

A foreign exchange market without any movements in the trend is a challenging climate to generate returns in, which is why conditions for currency funds look grim at present. However, after a long period of "range trading" (trading within an interval), movements can become large when the exchange rates between currencies wind up outside the previous range.

Euro surprisingly strong

Despite quite a few storm clouds in the euro zone, the euro has managed to remain at surprisingly strong levels. It seems natural that the euro should trade at a certain risk premium, given that the future seems uncertain in a number of countries. Granted, election results in Greece and France have caused some fluctuation, but considering political developments, there is surprisingly little movement. Nonetheless, there are several explanations for why Spain's problems and the prevailing political uncertainty in the euro zone have not yet had any clear impact on the euro exchange rate.

For several months, Asian central banks have aimed to reduce the dominant position of the US dollar in their currency reserves by investing more in other currencies. Since large, liquid currencies are preferable in a currency reserve, increased exposure to the euro has been a natural choice. During the crisis in southern Europe, the Chinese central bank has also purchased large volumes of bonds issued by crisis-plagued countries. China therefore has reason to buy euros in an effort to ensure that the value of the euro and of these bonds does not fall too much. As a result of financing for the euro zone's emergency funds, large sums are also being converted into euros (by the International Monetary Fund, among others). Finally, the European banking sector needs to reduce its risk exposure. This is done in part by selling securities outside the euro zone, which are then converted into euros. Flow trends are thus supporting the euro at present and may partially explain why the currency has not lost more in value.

USD preferable to EUR

The US dollar is weighed down by a substantial current account deficit. Moreover, it is an election year in the US, and the outcome is uncertain, to say the least. President Barack Obama's popularity has waned, and getting broad support on fiscal policy is not without its problems. On the other hand, in many respects the US economy is headed in the right direction at the moment. This includes a faster than expected improvement in the labour market and stabilising home prices. Better growth prospects provide support for the dollar, especially compared to the euro, since our forecast of a recession in the euro zone still stands. Moreover, given the sizeable risk of downside surprises from indebted members of the euro zone, our overall view is that the EUR/USD exchange rate will fall from 1.31 at present to 1.26 by the end of June this year. We also expect the Swedish krona to gradually appreciate somewhat against the euro, although it will not quite manage to keep pace with the dollar.

Yen likely to get cheaper

Since 2007, the yen measured against the currencies of Japan's most important trading partners has appreciated by about 40-45 per cent, but there are a number of arguments for a sharp weakening of the Japanese currency in the long term. Most analysts consider the yen overvalued at present. Based on SEB's calculations, the equilibrium rate against the dollar is somewhere around JPY 115 per USD, and a depreciation of around 40 per cent from today's level (JPY 80 per USD) is needed to reach this. Japanese authorities are also likely to welcome a weaker currency. That would help the export sector, thus bolstering the country's weak growth, and would ease deflationary pressure. A weaker currency may also be an effective tool to ignite inflationary growth, since foreign goods will become more expensive for Japanese consumers and companies ("imported inflation").

However, dark clouds persist on the market horizon. For instance, during periods when the focus is on southern Europe, there is great demand for the yen, since it is generally considered a safe haven. But in the long term, investors will probably question whether the appreciation of the yen is justified given Japan's substantial debt, low growth rate and extremely low interest rates. Historically, the yen's performance has been closely linked to interest rate differences between Japan and the rest of the world. When interest rates elsewhere have risen relative to Japanese levels, the yen has weakened and vice versa. As we described in our theme article "In search of lost returns" (page 19), interest rate levels will probably move upward in general. Still, Japan has pursued a zero interest rate policy for about 15 years, and there is nothing to indicate any change in its monetary policy, which most likely means the interest rate gap with the rest of the world will continue to widen and the yen will thus weaken.

Yuan has encountered resistance

For about a year, Chinese authorities have gradually let the value of the yuan increase against the dollar. But developments so far this year indicate that yuan appreciation has come to a halt. The currency pair has been trading at around CNY 6.30 per USD, and there are reasons why China is now choosing to take a break. Economic data from China over the past six months point towards a deceleration in the economy. Export growth has slowed as a result of weakening global demand, and the domestic market is expanding at a slightly slower rate than earlier. In addition, inflation pressure has eased considerably, which is also evidence against a continued strengthening of the yuan at present.

Although representatives from Chinese authorities have announced that the yuan is near its equilibrium rate against the dollar, there are both global and domestic reasons for a continued strengthening of the yuan in the long term. For the international economy, it is a matter of reducing global trade imbalances, and for China it is a matter of instead stimulating its domestic economy (a clear objective in the latest five-year plan). We expect yuan appreciation to continue, but at a slower rate than before. Our forecast is that the USD/CNY rate (trading at around 6.35 today) will be at 6.15 in December 2012.

ATTRACTIVENESS OF YEN LIKELY TO FADE

Since 2007, the yen has been in demand, appreciating by a full 40-45 per cent. However, over the next couple of years, a number of factors indicate that this trend will probably come to an end and we will once again see a weaker yen.