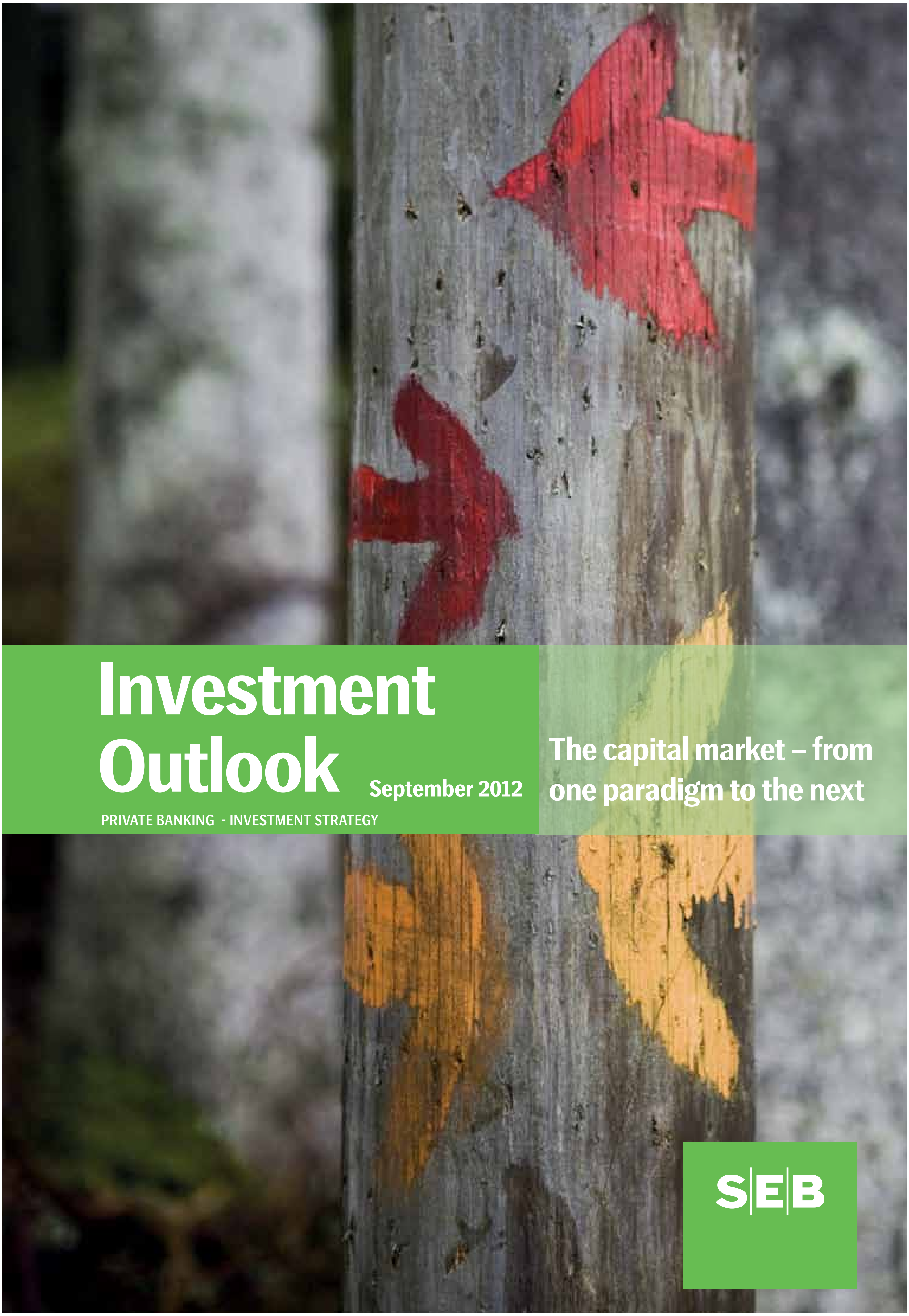

Investment Outlook

September 2012

PRIVATE BANKING - INVESTMENT STRATEGY

The capital market – from one paradigm to the next

SEB

Contents

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Hans Peterson
Global Head of Investment Strategy
+ 46 8 763 69 21
hans.peterson@seb.se

Lars Gunnar Aspman
Global Head of Macro Strategy
+ 46 8 763 69 75
lars.aspman@seb.se

Victor de Oliveira
Portfolio Manager and Head of IS Luxemburg
+ 352 26 23 62 37
victor.deoliveira@sebprivatebanking.com

Lars Granqvist
Fixed Income Strategist
+ 46 8 763 69 38
lars.granqvist@seb.se

Johan Larsson
Equity Strategist
+ 46 8 763 69 38
johan.larsson@enskilda.se

Esbjörn Lundevall
Equity Strategist
+46 8 763 69 62
esbjorn.lundevall@seb.se

Johan Hagbarth
Investment Strategist
+ 46 8 763 69 58
johan.hagbarth@seb.se

Jonas Evaldsson
Economist
+46 8 763 69 71
jonas.evaldsson@seb.se

Reine Kase
Economist
+352 26 23 63 50
reine.kase@sebprivatebanking.com

Daniel Gecer
Economist
+46 8 763 69 18
daniel.gecer@seb.se

Carl-Filip Strömbäck
Economist
+46 8 763 69 83
carl-filip.stromback@seb.se

Cecilia Kohonen
Communication Manager
+46 8 763 69 95
cecilia.kohonen@seb.se

Political fears mask fundamental opportunities

It is rare for everything to feel good at the same time. This statement is one that it is wise to reflect on now and then, especially if you are a capital market investor.

A feeling for what the problems may be and how they affect prices of securities is vital when investing capital. News headlines may often influence risk appetite and perceptions of the potential in different market segments. Over the past year, we have seen periods of high returns in many of the world's stock markets, and the long-term trend looks relatively good, but current assessments of the state of the world are characterised by worries and uncertainties. What is right? The price of a security is the sum of market consensus and, in that sense, the only truth; demand determines market performance. The challenge is to see through the media clutter and sort out fundamental trends. It is important to focus on sustainable long-term values rather than trying to capture short-term trends. If you have a long-term, steady approach, it is easier to build a portfolio that generates good returns, but the battle between strategy and tactics will continue in the market forever. So far during 2012, market behaviour has been extremely tactical, with rapid shifts in which the political climate has largely influenced investors' risk appetite.

There are now many indications that a new phase may be starting. A slightly less acute situation in Europe and a little more consensus among political leaders are generating increased confidence, greater transparency and optimism. If predictability becomes greater, it will also support a more stable market climate.

Market players who have been stubbornly defensive may reluctantly begin to move towards risk-taking. This is because the alternative consists of low interest rates and bond yields as well as shrinking risk premiums. This is the central banks' classic method, and they will keep it up until they achieve the desired effect.

The time is ripe for political leadership. Problems that have been partially caused by generous policies must and can only be handled by politicians. Confidence in decision making processes is crucial in determining the behaviour of businesses and consumers, and things are currently looking somewhat better in Europe. The US is waiting for the elections. If we are lucky, things may look better across the Atlantic after the elections. The US has problems, though; the national debt is growing rapidly and must be managed. Hopefully Washington will be able to do this. In our theme article, "Political agenda with great market impact," we examine risks and opportunities, timetables and players.

Investors have increasingly focused on the bond market in recent years. There have been very good returns on corporate bonds, and the number of issuers is increasing rapidly. The bond market has many pitfalls, especially in relation to the expectations that novice bond investors may conceivably have. Many investors are entering the bond market for the first time, and such concepts as credit risk, liquidity risk and especially interest rate risk are risks that one should have some idea of when building up a bond portfolio. We discuss and explain them in our theme article entitled "The credit market – complex and attractive".

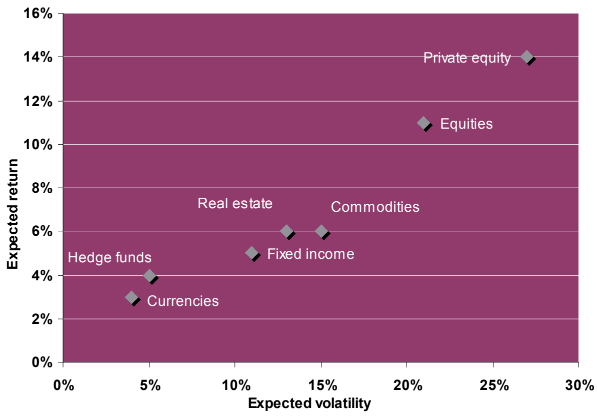
At present, it is easy to become defensive when the media provide extensive, in-depth reports about the problems in Europe and among U.S. policymakers. But despite weak economic data, we should see a recovery in parts of the world next year. There is thus a risk that the world will slowly heal while the media and media consumers are busy being problem-focused. Ultimately, the global economy is the sum of consumption and the desire of people to have a better life. For businesses this means investing, streamlining production and boosting sales. All these are natural, fundamental driving forces in a functioning economy. This will also be true now, and these drivers will generate growth. The question is how far the market will have had time to take off by the time the focus shifts from problems to opportunities.

HANS PETERSON
CIO Private Banking
and Global Head of Investment Strategy

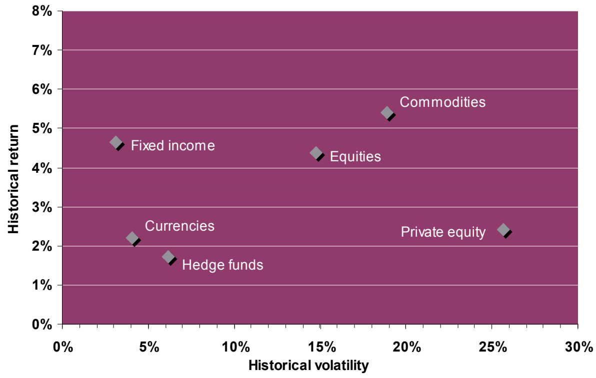
	Expectations* Next 12 months Return	Risk	*Forecasts are based on the SEB House View and our economic growth scenario (see page 8). Reasoning
Equities [1]	11%	21%	**NEUTRAL** in the short term – The economic picture has recently brightened somewhat and recession risk has been revised downward. The absolutely biggest driving force today is expectations and hopes that central banks will stimulate the world economy by expanding their balance sheets. **POSITIVE** in the long term. Being selective and focusing on good risk management is a suggestion to investors who wish to enjoy the opportunities that stock markets offer globally. Better potential in emerging markets than in the US stock market, which is at a four-year high.
Fixed income [2]	5%	11%	Still **NEGATIVE** towards government bonds in OECD countries. Given low inflation and further unconventional measures by central banks, government bond yields are nevertheless expected to rise eventually leading to falling government bond prices. **POSITIVE** towards government bonds in emerging markets, where diminishing inflation pressure is making room for falling bond yields=rising prices. **POSITIVE** towards corporate bonds in the high yield segment, where there are still arguments such as good company health and continued attractive yield gaps against government bonds. **NEUTRAL** towards investment grade corporate bonds.
Hedge funds	4%	5%	**NEUTRAL.** Political initiatives will increasingly steer the markets, making it difficult for managers who focus on the fundamental value of companies. The best potential exists for Relative Value and Macro strategies, which can play on global tensions between and within asset classes.
Real estate [3]	6%	13%	**NEUTRAL/POSITIVE.** Quality properties in primary markets remain attractive in a low interest rate environment. Differences in levels of return between primary and secondary markets have gradually increased and, to some extent, created new investment opportunities further out on the risk scale. The REIT market is reporting increased demand and is showing very good performance in 2012.
Private equity	14%	27%	**NEUTRAL/POSITIVE.** Continued de-coupling from financial sector shares is an advantage for listed PE companies, whose underlying net asset value (NAV) has recently climbed sharply. The trend is being favourably driven by strong portfolio prospects and, for mid-cap companies, reduced sensitivity to a more restrictive credit market. Measures aimed at reducing high discounts to NAV will increase the transparency and attractiveness of this asset class in the long term.
Commodities [4]	6%	15%	**NEUTRAL** After a period of volatile oil prices, we believe that prices will remain around current level for the rest of this year and seasonally decline marginally during the first half of 2013. Upside price risks if geopolitical unrest escalates. **POSITIVE** towards long-term exposure to base metals, since prices are now depressed. Best risk/reward ratio in aluminium and nickel, since these metals at present are being traded well below production costs. Due to under-investments for many years, we have a positive view of platinum prices ahead. For gold, we foresee an upside risk during the autumn and a relatively neutral trend in a one-year perspective. In our assessment, most of the rally in agricultural commodities is over, and we are **NEGATIVE** and expect sharply falling prices in a one-year perspective.
Currencies [5]	3%	4%	**NEUTRAL** towards the USD and EUR. Low growth and slimming of deficits will have a clear impact on the foreign exchange market. If a third round of quantative easing (QE3) in the US is launched the USD risks weakening further, and if the ECB begins sovereign bond purchases the EUR should temporarily appreciate. **NEUTRAL/POSITIVE** towards emerging market currencies. Higher interest rates than in OECD countries and better growth prospects point towards gradually rising exchange rates for EM currencies.

[1] The forecast refers to the global stock market. [2] The forecast refers to a basket of ½ investment grade and ½ high yield corporate bonds. [3] The forecast refers to the REIT market. [4] The forecast refers to a basket in which the energy, industrial metal and precious metal categories are equally weighted. [5] The forecast refers to the alpha-generating capacity of a foreign exchange trading manager.

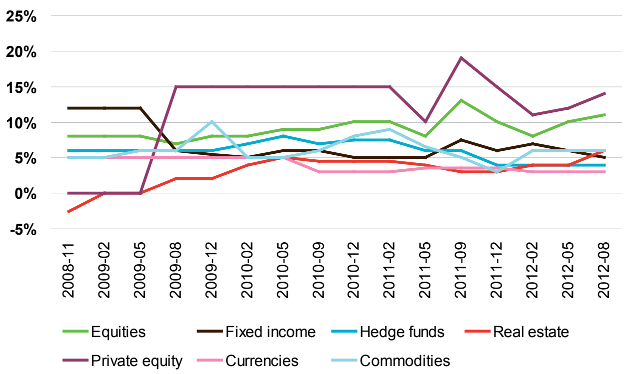
EXPECTED RISK AND RETURN (NEXT 12 MONTHS)



HISTORICAL RISK AND RETURN (SEPTEMBER 30, 2002 TO AUGUST 31, 2012)



CHANGE IN OUR EXPECTED RETURN

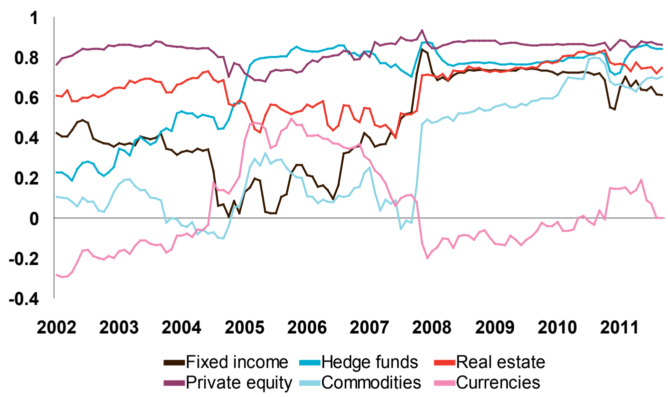


HISTORICAL CORRELATION (SEPTEMBER 30, 2002 TO AUGUST 31, 2012)

	Equities	Fixed income	Hedge funds	Real estate	Private equity	Commodities	Currencies
Equities	1.00						
Fixed income	-0.44	1.00					
Hedge funds	0.61	-0.30	1.00				
Real estate	0.80	-0.20	0.56	1.00			
Private equity	0.85	-0.35	0.67	0.88	1.00		
Commodities	0.27	-0.18	0.67	0.29	0.39	1.00	
Currencies	0.11	0.17	0.16	-0.10	-0.02	0.03	1.00

PLEASE NOTE: In August 2012 we changed real estate index from SEB PB Real Estate to EPRA/NA-REIT

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



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 = EPRA/NA-REIT EUR.
Private equity = LPX50 EUR.
Commodities = DJ UBS Commodities TR EUR.
Currencies = BarclayHedge Currency Trader USD.

A slow but less risky economic journey

- *The global economy will move ahead in low gear this year and next...*
- *...but new policy perspectives have reduced cyclical risks in OECD countries*
- *In 2014 the pace will quicken, with more self-sustaining growth*

The global economy lost momentum last spring, with the industrialised countries of the Organisation for Economic Cooperation and Development (OECD) as the main hindrance. This loss of speed was widely synchronised. Emerging market (EM) economies also decelerated, but Nordic countries continued to show good resilience. Overall world growth is not yet self-perpetuating, since ongoing reductions in budget deficits and in household, business and government debts mean that economies need support from central banks. During 2013 and 2014, global growth will nevertheless gradually climb and become increasingly self-sustaining.

Financial markets were unhappy last spring, but since the end of the first half of the year their mood has improved thanks to further monetary policy easing and progress in managing the European sovereign debt crisis. Difficult economic policy choices – especially in Europe – will determine developments in a slightly longer perspective. The steps now being taken will probably help stabilise conditions in the medium term, although the situation remains fragile and there are major unanswered questions. Because of the brighter economic policy outlook compared to last spring, our assessment now is that cyclical risks no longer predominate; instead, the risk picture has become symmetrical.

The American economy will speed up in 2014

The danger of a new recession in the United States has diminished. Housing and other cyclical sectors are rebounding after a weak patch last spring, while broader-based macroeconomic statistics have improved and in many cases surpassed expectations, but a combination of debt deleveraging, low international demand, a weak labour market and fiscal tightening will hold back growth this year and in 2013. We foresee GDP growth a bit above 2 per cent both this year and next, accelerating to more than 2.5 per cent in 2014. Modest growth along with calm inflation will give the Federal Reserve reason and manoeuvring room to launch further stimulus measures, and our forecast is that the Fed will approve a third round of quantitative easing through bond purchases (QE3) during the second half of 2012.

Euro zone problems require fresh political approaches

In the second quarter, overall euro zone GDP declined. Leading indicators point to a decline this quarter as well. Even Germany's previously rather rapid growth seems to be moving towards a slowdown. We expect euro zone GDP to shrink by nearly 0.5 per cent in 2012, rise by a marginal 0.2 per cent next year and grow by less than 1 per cent in 2014. The situation in Greece has stabilised somewhat. A shrinking economy combined with widespread tax-dodging and faulty tax collection systems are counteracting the effects of austerity measures. In Spain the government continues to carry out its crisis policies but is under pressure from political protests, unemployment of around 25 per cent and a continued decline in home prices. The economic crisis will require fresh approaches. And despite opposition from Germany's Bundesbank, the European Central Bank (ECB) seems prepared to shoulder greater responsibility for stabilising the euro and helping crisis-hit countries via sovereign bond purchases. The ECB will probably also lower its key interest rate further from today's 0.75 per cent.

British economy has lost ground amid fiscal tightening

British GDP has fallen for three straight quarters, and the economy has lost ground to other countries. One explanation is that the UK has implemented larger budget austerity measures than Germany and the US, for example. We forecast that GDP will decline by nearly 0.5 per cent this year and then grow by at least 1.5 per cent in 2013 and 2014. Weak economic conditions and falling inflation will pave the way this autumn for the Bank of England (BoE) to raise the ceiling for its bond purchases from the current GBP 375 billion, but the BoE is unlikely to lower its key interest rate from the current 0.5 per cent.

Nordic countries still resilient

The export-dependent Nordic economies are being squeezed by lacklustre global economic performance, but relatively stable labour markets are benefiting domestic demand. Despite support from a weaker euro (the Danish krone is pegged to the euro in the ERM 2 system), growth is lowest in Finland and Denmark. The Swedish economy is more vigorous but will decelerate next year because of the strong krona. Norway is the outlier: high oil prices and strong domestic demand will offset weak international markets and the strong Norwegian krone by a wide margin. Overall Nordic GDP will grow by well over 1.5 per cent this year, nearly 2 per cent in 2013 and more than 2 per cent in 2014.

Reconstruction work supports growth in Japan

Reconstruction work after the 2011 natural disasters and stimulus measures aimed at households helped boost Japanese GDP sharply early this year, and 2012 as a whole looks set to be a good year for the economy, with growth of more than 2.5 per cent. Rather low Asian demand and a shift from fiscal expansion to tightening – government debt will still reach nearly 250 per cent of GDP in 2014 – will then cause GDP growth to decelerate to around 1.5 per cent in 2013 and 2014. Tighter fiscal policy will be partly offset by further monetary easing, with the Bank of Japan expected to expand its quantitative easing (asset purchase) program later this year.

Emerging Asia providing support to world economy

Asia's emerging economies are now being held back by weak international demand and past economic austerity measures. Yet our assessment is that strong domestic demand, driven by a shift to more economic policy stimulus as well as low household debt and good wage growth, will help sustain decent growth in emerging Asia over the next couple of years. This will provide much-needed support to the rest of the world economy. While China's year-on-year growth cooled to over 7.5 per cent in the second quarter – the sixth such consecutive quarterly decline – this summer's macro statistics indicate that the economy is moving towards stabilisation. We predict that GDP will increase by about 8 per cent annually in 2012-2014. Due to decelerating growth and inflation, since May the People's Bank of China has lowered its key interest rate to 6.00 per cent. In our assessment there will be a couple of further key rate cuts this year, and bank reserve requirements will be lowered further. In India, the economy has also decelerated – more significantly than that of China – mainly due to weaker capital spending. Meanwhile a large budget deficit along with stubbornly high inflation will leave very limited room to stimulate the economy in the short term. However, a couple more key interest rate cuts this autumn still remain in our forecast. We expect India's GDP to grow by about 6 per cent both this year and in 2013, and by 6.5 per cent in 2014.

Limited loss of momentum in Latin America

The overall Latin America economy has also lost some of its dynamism, but in most countries the slowdown has been limited. Looking ahead, higher domestic demand will benefit growth in many places. While GDP growth in the region will cool to about 3.5 per cent this year, we expect it to accelerate and reach around 4 per cent next year and slightly higher in 2014, but there are major differences between countries. Brazil is dominated by a weak manufacturing sector in the wake of rising labour costs and an expensive currency. In Mexico, growth is being sustained by good exports to the US. Strong domestic demand is providing support in Chile and Peru, while lower prices for certain commodities mainly risk hurting Argentina and Venezuela in particular.

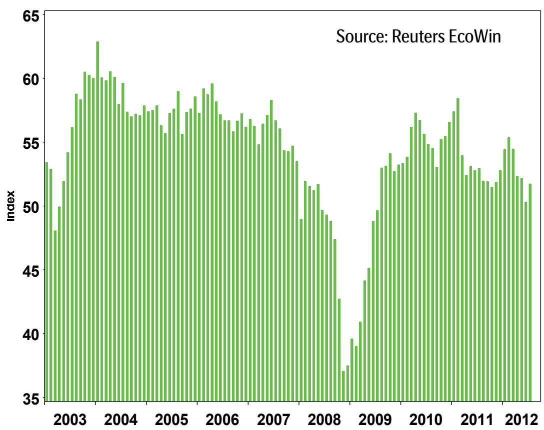
Varying prospects for Eastern European economies

Economic indicators in Eastern (including Central) Europe have stabilised this summer after earlier relatively sharp declines. Growth will slow this year and recover only a bit during 2013, hampered by weak demand and banking system woes in Western Europe. Meanwhile the increasingly apparent polarisation in Eastern Europe will continue. Russia and Poland will cope well with the euro zone crisis, while some central and especially southern parts of the region will be relatively hard hit. Hungary, the Czech Republic, Croatia and Slovenia will report recessions this year and marginal growth in 2013. Bulgaria, Romania, Slovakia and Ukraine will note only very small GDP increases.

After the past year's deceleration in exports, growth in the Baltic countries will improve successively during 2013-2014. Gradually rising domestic demand will cushion the three economies as the export engine continues to sputter in 2013, but all of the Baltics are struggling with significant structural problems in the labour market, caused by the new emigration wave of recent years and unfavourable demographics. We believe that GDP in the region will grow by more than 3 per cent this year, over 3.5 per cent in 2013 and 4.0-4.5 per cent in 2014. We expect Latvia to meet the criteria for its planned euro zone accession in 2014. Lithuania also aims at euro zone membership in 2014 but is in somewhat worse shape in terms of meeting the criteria. The country is thus unlikely to adopt the common currency until 2015.

We foresee fewer world economic risks

Overall, we expect the world economy to expand by less than 3.5 per cent this year and then speed up somewhat in 2013. Not until 2014 do we predict growth of more than 4 per cent. Our forecasts show that the emerging market sphere will continue to show a significantly faster pace, with GDP increases of 5-6 per cent annually in 2012-2014, compared to roughly 1.5-2 per cent in the OECD countries. Compared to last spring, the downside risks in the OECD economies have diminished, mainly thanks to more favourable economic policy prospects.



MORE POSITIVE WORLD ECONOMIC GROWTH TREND IN 2013-2014

Since late 2010 the world economic situation, as measured by the JP Morgan/Markit global purchasing managers' index (chart), has fluctuated noticeably, with a downward trend. Our forecasts indicate that global economic conditions will gradually strengthen during the next couple of years, but fluctuations are likely to persist.

Portfolio commentary: Modern Investment Programmes

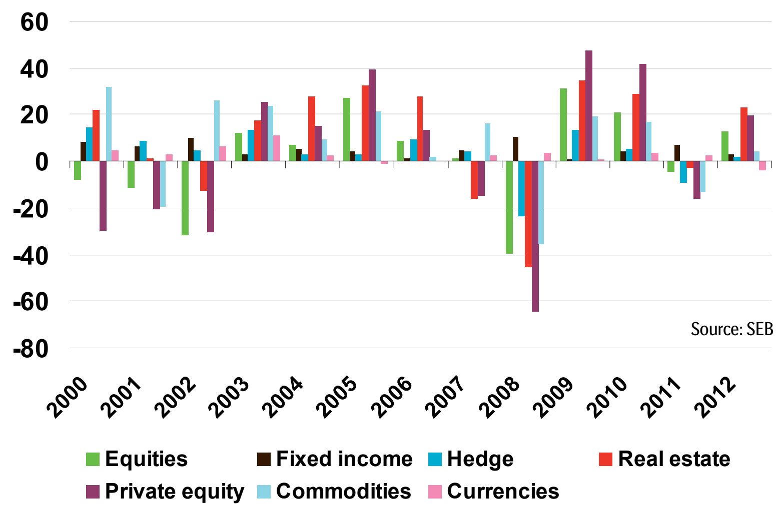
Sound risk-taking instead of maximum returns

Risk diversification is the key to stable portfolios, but merely spreading risks across asset classes is not the entire solution. For example, a naïve combination of Chinese equities and industrial metals may provide exaggerated exposure to China's economy, which tends to drive the returns on both these asset classes. Investments in Russian equity funds may result in excessive sensitivity to oil prices if the portfolio already includes commodity funds. In structuring a portfolio, it is thus important to strike the right balance between asset classes in order to achieve the desired exposure to underlying market drivers.

In the Modern Investment Programmes, however, we not only focus on the drivers underlying asset classes, but also on manager risk. Given the right combination of asset managers, we can achieve a portfolio profile with the potential to perform better than the benchmark index, but the wrong combination or an excessive diversification among managers may ultimately mean that our overall exposure will too closely resemble that of the index.

For each portfolio, we thus seek the right balance between asset classes, market drivers, managers and investment themes. The focus of Modern Protection is on balancing fixed income and credit risk, while Modern Growth and Modern Aggressive seek various forms of exposure to the underlying global economic recovery. At present, the portfolios are generally defensive, but in the current environment we believe it is justified to focus more on sound risk-taking than on trying to chase the last percentages of returns.

PERFORMANCE OF DIFFERENT ASSET CLASSES SINCE 2000



Return in 2012 is until August 31.
- Historical values are based on the following indices: Equities = MSCI AC World EUR. Fixed income = JP Morgan Global GBI EUR Hedge. Hedge funds = HFRX Global Hedge Fund USD. Real estate = EPRA/NA-REIT EUR. Private equity = LPX50 EUR. Commodities = DJ UBS Commodities TR EUR. Currencies = Barclay Hedge Currency Trader USD.

MODERN PROTECTION

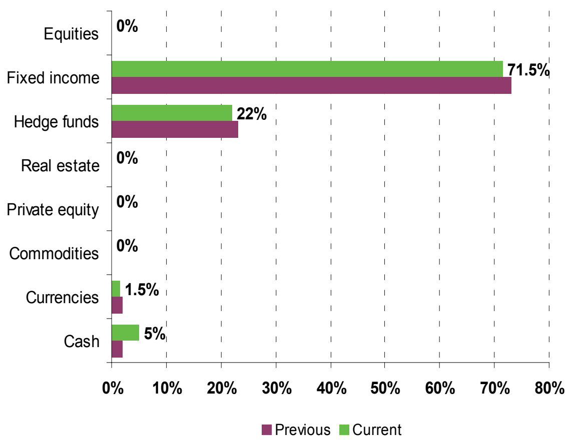
At this writing, the yield on two-year German sovereign bonds is in negative territory, which means that investors are willing to pay the German government to deposit their money. In today's low interest rate environment, the key is thus to invest in sound corporate debt securities in order to keep up with inflation.

But buying corporate bonds alone is not the best solution. Even if companies have sound finances, the differential between yields on corporate debt and government bonds (credit spread) tends to fluctuate with macroeconomic news and statistics, risk appetite and liquidity. If government bond yields rise, bonds lose value in the short term. In order to achieve stable returns, we must therefore keep interest rate risk down while neutralising major fluctuations in credit spread.

We address interest rate risk by investing in corporate bonds with low interest rate sensitivity. In the investment grade segment, we take such a position through the BlueBay Investment Grade Libor Fund, which neutralises interest rate risk by means of credit derivatives. This means that the fund's expected internal yield will also be lower, but its risk/return profile fits better into the Modern Protection management mandate. In the high yield segment, a majority of our investments are in JPMorgan Highbridge Leveraged Loans. The fund invests in loans to companies with low credit-worthiness, but the interest rates on these are connected to 3- or 6-month Libor rates. This means that interest rate sensitivity is essentially nonexistent.

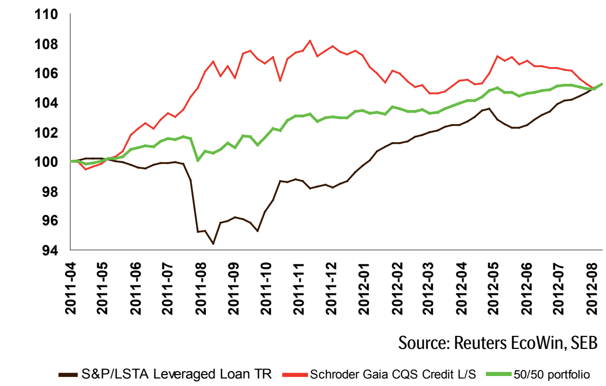
Aside from actively increasing or decreasing our allocation to corporate debt generally, we manage credit risk through Credit Long/Short hedge funds, in which the manager tends to be short in the credit market. This mandate has shown weak performance as credit spreads have narrowed dramatically in recent months, but on the other hand they have delivered strong returns during periods of expanding credit spreads. During periods of small movements, the mandate has performed modestly but positively. A combination of our Credit L/S manager and Leveraged Loans provides a stable return trend.

WEIGHTS IN MODERN PROTECTION



Source: SEB

COMBINATION PROVIDES STABLE RETURN TREND



Source: Reuters EcoWin, SEB

Credit Long/Short managers tend to maintain short positions in the market. Volatile credit spreads have contributed to choppy performance, but the combination of a Credit Long/Short manager and Leveraged Loans results in a stable return trend.

A large proportion of the portfolio (about one third) is in fixed income funds with free investment mandates, or Absolute Return, which can generate returns regardless of interest rate movements. Returns are very dependent on the manager, however. We combine four different managers who all have different styles and time horizons – for example Pimco Unconstrained Bond is more fast-moving in its allocations, while JPMorgan Income Opportunity tends to focus on more long-term trends and mis-pricing.

Credit spreads have narrowed sharply in recent months. This has benefited the portfolio, but we now see somewhat greater risks of widening credit spreads. We thus increased our allocation to Credit Long/Short somewhat during August. Overall, the portfolio is well-balanced, with low interest rate risk and modest credit risk, and should be able to generate returns regardless of what direction interest rates are moving.

MODERN GROWTH

Modern Growth has the objective of providing a return at the level of the stock market over an economic cycle, but at lower risk than the stock market. According to Elroy Dimson, Paul Marsh and Mike Staunton in the *Credit Suisse Global Investment Returns Sourcebook 2012*, equities returned around 7 per cent annually from 1900 to 2011 (adjusted for inflation), which thus becomes our targeted return in the Modern Growth portfolio. The economic outlook is still shaky, however, and although the risk of a global recession has decreased from 25 to 20 per cent according to SEB, a cautious approach to equity risk in general is justified. This is reflected in the portfolio.

Given uncertain economic prospects and record-low government bond yields, the theme of recent years has been to find stable revenue streams such as interest income and dividends. The risk scale runs from corporate bonds with high credit-worthiness (investment grade) via corporate bonds with low credit-worthiness (high yield), convertible bonds and finally equities with high dividend yield. Today investment grade bonds pay about 2 per cent in euros while high yield bonds offer a current yield of about 7 per cent. Emerging market bonds also provide a yield of about 6 per cent, with a potential for exchange gains. Equities with high dividends provide a yield of about 4 per cent.

In Modern Growth we focus on this theme mainly through the high yield segment, which totals about 30 per cent of the portfolio. This asset class offers a yield at the level of our overall targeted return of 7-8 per cent, while the risk is lower than for equities, and is therefore a fundamental building block of the portfolio. But just as it is important to diversify between asset classes, it is also important to spread our risks in terms of investment themes. In equities, we thus invest with more growth-oriented managers, both to avoid being exposed only to the "yield" theme and to have better potential for appreciation in more positive cyclical scenarios.

In the equity sub-portfolio (nearly 17 per cent of Modern Growth), more than 11 percentage points are in global equities, nearly 5 percentage points in emerging markets and 1 percentage point in Nordic equities. We also spread the thematic risk in the overall portfolio by investing with managers who seek equities with high growth and return potential regardless of dividend yield. Since the market generally favours defensive equities with high dividend yields, these managers are facing headwinds to some extent, but in a scenario where the market is becoming less worried and is shifting its focus towards long-term growth, these managers should pick up a tail-wind. In this way, we are balancing the risks in the portfolio and at the same time benefiting from a potentially more positive economic scenario.

Even if we spread our risks within and among asset classes, we see that the correlation between them is fairly high from a historical perspective. As indicated in Table 1, high yield and commodities in particular are more correlated to equities than before. This means that the effect of diversifying risks among these assets classes is lower today. This is why about 30 per cent of the portfolio is invested in hedge funds, which should be capable of providing a return regardless of general market direction. In this asset class, we focus primarily on Credit Long/short strategies, which offset the credit exposure we have through high yield and CTA strategies*.

CORRELATIONS AGAINST OECD EQUITIES (MSCI WORLD)

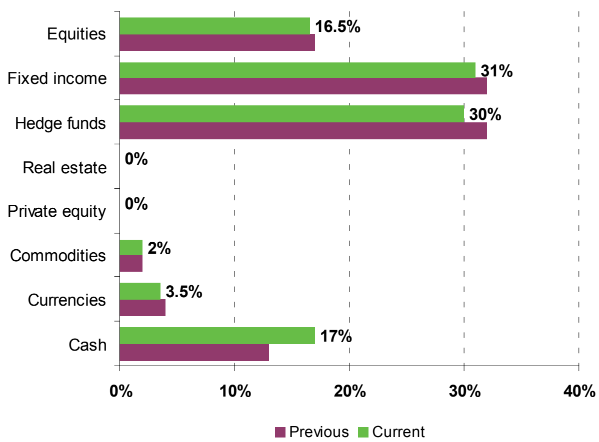
Asset class	Jun 30 2012	Jun 29 2007	Index
Government bonds	-0.54	-0.15	JPM Global GBI
EM equities	0.75	0.82	MSCI EM
High Yield	0.68	0.34	iBoxx US High Yield
Private equity	0.89	0.88	LPX50
Commodities	0.42	-0.07	DJ UBS Commodities TR

Correlations counting 24 months of monthly returns.

Source: SEB

The portfolio is defensively positioned, with about 17 per cent cash, which is justified considering the uncertainty surrounding the political process in Europe. Given our current allocation, expected return is somewhat lower than our long-term objective of 7-8 per cent, but it also means that looking ahead, we are well prepared to act when better buying situations materialise.

WEIGHTS IN MODERN GROWTH



Source: SEB

** CTA managers (systematic management based on computer models)*

MODERN AGGRESSIVE

In Modern Aggressive, like Modern Growth, we focus on the theme of current return/yield by means of riskier corporate bonds. As in Modern Growth, the fixed income sub-portfolio totals 30 per cent, but in Modern Aggressive we attach more importance to the potential for rising asset prices. This is why we have a larger share of the overall portfolio in emerging market debt (about 8.5 per cent, compared to 2.5 per cent for Modern Growth), where we foresee a major opportunity for foreign exchange gains, in addition to the 5-6 per cent yields that EM bonds offer. High yield bonds thus account for about 21.5 per cent of the portfolio.

Given the objective of the Modern Aggressive Portfolio – a return that surpasses that of the stock market over an economic cycle – riskier asset classes such as equities and commodities play a larger role as engines of returns. The allocation to these assets today is about 42 per cent, and for natural reasons the portfolio is thus more sensitive to market fluctuations in the short term and general economic developments in the longer term.

Looking at the equities sub-portfolio, global equities account for 26 per cent, EM equities 9 per cent and Nordic equities 3 per cent of Modern Aggressive. Among global managers, JO Hambro has shown the best performance so far this year through its focus on the information technology sector. At this writing, JO Hambro has provided returns about 2 percentage points better than the world index, while the global portfolio as a whole has performed worse than the index. This has been offset by our emerging market managers, however. William Blair Emerging Leaders is the strongest performer, with a 13 per cent increase this year or about 6 percentage points above the MSCI Emerging Markets index. Our focus on Asia and choice of managers in the region has also paid off – while the MSCI Asia Pacific ex Japan Index has risen by about 11.6 per cent, our holding in T Rowe Price Asia ex Japan has gained more than 14 per cent.

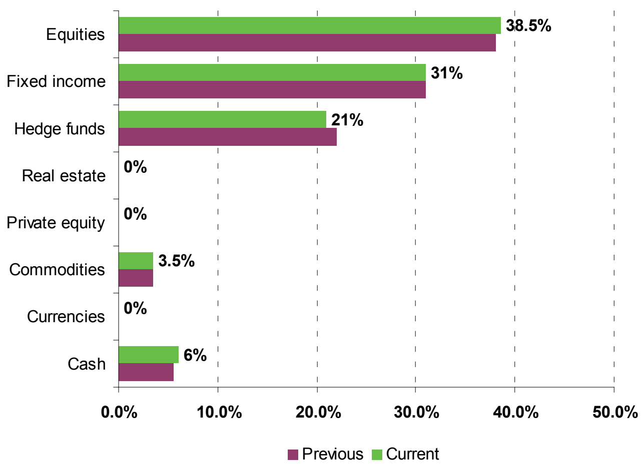
Commodities as an asset class lost more than 14 per cent from March to May but have recovered since then, with an upturn of 14 per cent, and our commodities investment manager likewise. Our exposure is a modest 3.5 per cent, however, and has not affected the portfolio to any great extent.

About 21 per cent of Modern Aggressive is invested in hedge funds, with a focus on MultiStrategy (10 per cent of the overall portfolio), CTA (6.5 per cent) and Credit Long/Short (3.5 per cent). CTA strategies*, in particular, have had difficulty generating returns in today's trendless markets, but during May and June occasionally neutralised downturns from our exposure to equities.

We are still focusing on good risk management, and our forecasts indicate that in a recession scenario the portfolio may lose about 15 per cent, which is lower than the risk for the stock market generally. This is due to our general risk diversification and to the fact that the portfolio is defensively positioned, with about 6 per cent cash. Today the expected return is about 7 per cent, which is somewhat lower than our targeted return, but we are choosing to keep down risk rather than chasing the last percentage points of returns.

** CTA managers (systematic management based on computer models)*

WEIGHTS IN MODERN AGGRESSIVE



Source: SEB

Capital markets – from one paradigm to the next

- *Will politics relax its grip on the markets?*
- *Shrinking risk premiums in the bond market are one argument for equities*
- *Currently limited risk appetite is about to grow*

Having gone through a period dominated until this summer by crisis management and European politics, the financial world may now be entering a new phase. After seeing risk appetite rise and fall as headlines and actual events changed the market's view of global growth, we can now begin to talk about a degree of stability in market perceptions of Europe.

Questions about how the financial system should be designed and how to finance governments in the future were high on the agenda, and they remain so. But given slightly more stable surroundings, along with fundamental economic trends, there may be reason to reflect on the difference between good and bad risks and how to position ourselves in the capital markets.

It is important to remember that the problems in Europe are far from solved. Leaders still need to address structural reforms, fiscal issues and mechanisms for continued financing of budget deficits. Funding should preferably occur at national level, but in some cases at euro zone level, for example via the European Stability Mechanism (ESM), a bail-out fund.

Yet because of the steps that have actually been taken, the overall picture is better, which also leads us to believe today that the risks of really weak economic activity have diminished. According to SEB's economic forecasts, recession risk has declined to 20 per cent while the probability of a better scenario than the main scenario is also 20 per cent, a nice symmetry. The intriguing question is: How will this change investor behaviour?

To make such an assessment, we need to start by asking how market participants are positioned today. How have they priced securities at different levels of risk, and how is this reflected in asset valuations? Generally, we can approach the question by looking at how capital market players have taken risks. One way is by looking at hedge fund performance.

This year we have had a relatively positive trend in parts of the capital market. In many regions, equities have provided rather good returns – quite a volatile journey, but still positive. Parts of the bond markets have also done well: high yield bonds – corporate bonds with slightly higher credit risk – have risen almost 10 per cent so far this year (as measured by iBoxx in USD). Despite relatively good markets, hedge funds as a group have not provided especially high returns. The broad HFRX index has shown a 2.15 per cent gain this year (in USD terms). The sub-index reflecting stock market-driven hedge funds, HFRX Equity Long/Short, has risen by 2.48 per cent (in USD).

The seemingly obvious conclusion is that most hedge fund managers have distanced themselves a little from the opportunities the market has provided, that is, they have had a defensive attitude – reflecting a low risk appetite. Fund inflows and outflows are another way to measure how a broad investor category perceives risk. Such a measurement leads to the simple conclusion that most capital is being allocated to fixed income funds.

The financial information and news agency Bloomberg continuously measures investors' risk appetite, which previously showed strong, rapid fluctuations driven by news headlines. Recently, however, it has tended to stay more constantly below the level that denotes a high risk appetite.

Finally, we can reflect on how the market has priced various types of assets. Today there is no doubt that cyclical shares have definitely been under-priced, and investors have prioritised defensive shares with high dividends.

In the bond market, the focus has shifted between different types of bonds, ranging from government bonds in "risk-free" countries, i.e. countries without fiscal problems – which now periodically offer negative interest rates – to corporate bonds of varying credit quality, to which investors have allocated much of their capital. This in turn has caused yield margins (credit spreads) between corporate and government bonds to shrink dramatically in many cases. For corporate bonds with high credit quality (investment grade), the spread against government bonds is now so small that any increase in interest rates may seriously disrupt investor calculations. That brings us to the question of what risks can be labelled as good and which ones should be classified as bad, and what investment opportunities the answer to that question would then provide.

The markets in a new scenario

We might ask what will happen in capital markets if we enter a period of less anxiety, lower global recession risk and relatively predictable development, but characterised by low growth. In its latest economic forecasts, SEB points to slow but stable growth both this year and in 2013 and clearer recovery in 2014, when we project global growth of 4.1 percent – a relatively good level. The pattern will be the same as in recent years: slow growth in developed countries and significantly faster growth in emerging market (EM) countries. Looking ahead, if we are more confident about growth and if the risk of genuine economic crashes decreases, it is reasonable to expect slightly better performance for asset classes in the higher risk segment. Risk propensity is a function of confidence, which in turn is a function of feeling secure about future developments and greater predictability.

Threshold to the stock market not especially high

We note that a large proportion of the world's institutional asset managers (hedge funds, etc.) have apparently been relatively risk-averse. Their performance is generally weak, but not negative; a lot of capital is flowing into the expanding corporate bond market, and trading volume in world stock markets is record-low. In the past year, corporate bonds have generated better returns than shares in general (see chart). But if we enter the above-described phase – with reduced anxiety but continued low global growth, and with even lower interest rates, thus narrowing credit spreads – bonds will not be a self-evident investment in the same way. In itself, the lack of potential returns will move capital into stock markets.

Equity valuations do not indicate heavy demand; quite the contrary. But as indicated above, we may well be entering a period where investors are willing to pay more for shares, with rising valuations as a result. We are already seeing some signs of this in Sweden.

Today's valuations are favourable in terms of dividend yields. We can observe that dividend yields are higher than bond yields. In other words, we receive a premium for taking equity risk. The risk premium should disappear or at least shrink if the economy becomes, or is perceived as, more stable. Other valuation measures are also at record-low levels in many cases, leading us to believe that there may well be a shift that causes a surge in valuations. Our conclusion is that there is certainly scope for an upward revaluation of equities.

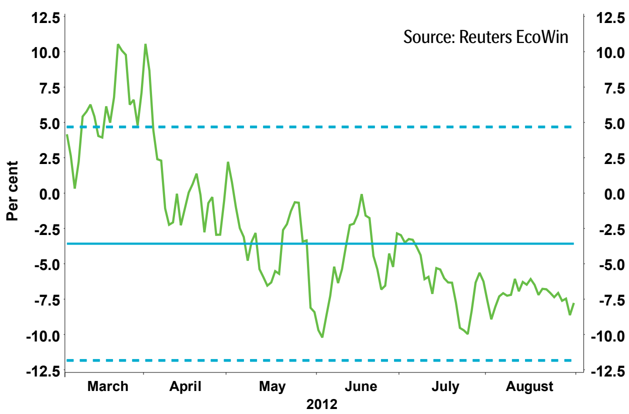
Stock markets – sector rotation may be under way

In the stock market, one of the most obvious opportunities is the difference in pricing between cyclical and defensive shares. The latter category has been the focus of the past year, and today's pricing differential is to the advantage of cyclical shares. It is true that in many cases it is still attractive to invest in companies with high dividends, and cyclical companies are dependent on economic stabilisation, but since this is our main forecast, we foresee opportunities for sector rotation. Looking at regions, it is worth noting that last year the US had one of the best performing stock markets (with the S&P500 close to a four-year high), while the best earnings growth was found in Asian emerging markets.

Commodities – potential for metals

Turning to commodity markets, we can draw a parallel with stock markets. In themselves, commodity indices have rather pale forecasts, but the performance of different commodity categories varies greatly. Due to a major US drought, prices of agricultural commodities have soared, while prices of industrial commodities have fallen sharply. In some cases, they are below or very close to production costs; this means, for example, that mines are closing. There is a significant price upturn potential here, just as in the case of cyclical stocks.

Among commodities, there is also reason to reflect on oil pric-



HIGH YIELD AHEAD OF EQUITIES IN RECENT MONTHS

The relative performance of equities and high yield bonds, measured as six-month rolling averages, has fallen during the past year because high yield bonds have provided better returns than equities. The return ratio is well below the historical average but will probably rebound if we enter a phase of reduced worries but continued slow global growth with accompanying low interest rates.

es. It is interesting to note that no matter how weak growth is, oil prices remain at high levels. Today we can probably rule out the risk that speculative capital has pushed up prices. Current oil price levels provide good opportunities for continued extraction and exploration, and this is one of the most attractive sectors in stock markets today.

Bond markets – still attractive

Though already part of the way through, we are still in a very special phase for bond markets. We have seen a lengthy and very sharp downturn in yields, boosting the value of bonds issued at higher levels. Moreover, we have seen that in the corporate bond market, spreads between government and corporate bonds have narrowed substantially, contributing to extremely good returns. Now that conditions have changed, we must revise our expected return on corporate bonds. The potential is lower than 12 months ago, although the levels are still good. The asset class nevertheless remains attractive, since risk in terms of volatility is low relative to the stock market. One reflection is that in essence, corporate bonds with short maturities pay returns as high as those with longer maturities, making them an interesting possibility in the current situation.

From a strategic perspective, and provided that our main forecast – with more mature markets seeing slow but steady growth and greater transparency – comes true, there are some specific themes that we believe to be of interest.

Opportunities based on changing economic trends:

Cyclical vs defensive shares: cyclical shares are well-priced and have great potential.

Industrial commodities and equities related to them.

Sectors with low valuations and stable growth in the global equity market, selected emerging markets (which are lagging the US), China for example. The interesting thing is that nowadays there are significant differences in performance between regions, partly justified in economic terms, but this is also an effect of low risk appetite (which we believe will increase).

Opportunities based on stable returns:

Based on a stable interest rate and economic scenario, corporate bonds with somewhat lower credit ratings – high yield bonds – remain attractive. They do not have the same potential as a year ago, but still offer good returns with manageable risk.

One idea is to switch between corporate bond categories, employing “arbitrage” between credit quality and maturities. The idea is to move from long investment grade to short high yield; we end up with much less interest rate risk and higher current returns.

Shares of companies in oil services: those that support oil extraction in different ways. Oil prices are high and demand is stable, while these companies offer attractive valuations.

Shares in companies exposed to stable, growing private consumption globally are of interest. The global recovery will be partly fuelled by consumption growth.

Shares in technology and growth companies are attractive, since in many cases their growth is independent of economic cycles.

Making comparisons between yields on equities and corporate bonds can often pay off or at least make us ask an important question: what is good risk? In some cases, dividends of stable companies are well above yields on corporate bonds, provided we are thinking long-term, which we should be doing with bonds that offer these yields (holding them to maturity); in many cases the conditions are good for buying equities instead.

Political agenda with great market impact

- *The financial crisis has activated the economic policy toolkit on a large scale*
- *Global economic prospects and future risk appe tite will be determined by events in the euro zone*
- *Prospects of fiscal and monetary policy success now seem brighter than before, but risks must not be underestimated*

This summer marks five years since the most serious global financial and economic crisis in modern times broke out in earnest, a drama clearly reflected in the financial markets. The aftershocks in the wake of this profound crisis have been numerous and have had a major impact on markets. These serious financial aftershocks have activated the economic policy tool arsenal, especially in the OECD industrialised countries, and this has happened on a nearly unprecedented scale:

Emergency actions that use public budget funds to rescue the financial system have been absolutely necessary to prevent systemic collapses and even deeper economic depression.

Central bank monetary policies characterised by zero interest rates and massive purchases of government bonds in particular (quantitative easing, QE) have, in all essential respects, been very well received in financial markets.

National fiscal policies have taken a significant tightening and thus growth-inhibiting path due to the need to reduce public sector budget deficits and halt the growth of government debt. Market reaction to these policies has varied. During 2012 they have been questioned, because overly tough policies risk strangling the economy and thus further impairing public finances. The focus has instead shifted towards policies that both improve public finances and benefit national economic growth and competitiveness.

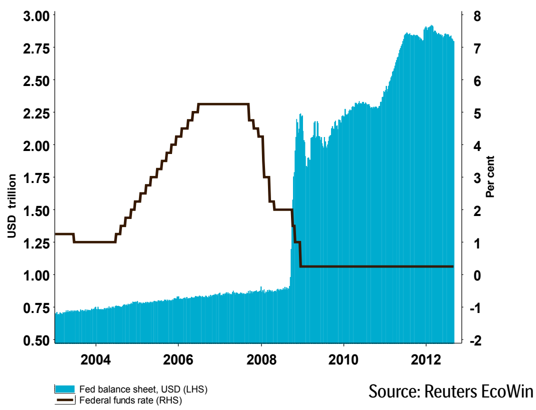
Supranational policies in the European Union and the euro zone since the spring of 2010 have focused on saving the euro currency and the euro project. Until this past summer, these policies were characterised by emergency responses launched at "five minutes to midnight". But when European political actions such as decisions on the European Financial Stability Facility (EFSF, a temporary bail-out fund) and the European Stability Mechanism (ESM, a permanent fund) were finally achieved, they led to positive market reactions.

Economic policies at the global level – in which discussions and cooperation among the Group of 20 (G20) countries and at the International Monetary Fund (IMF) play a pivotal role – have set their sights on addressing the imbalances and excesses that caused the financial and economic crisis, but ensuring that the necessary austerity measures do not strangle global economic growth. Another ambition is to strengthen the resilience of the global financial system.

Paths, choices and financial market reactions ahead

What paths are economic policy makers likely to take in the future? What are the most difficult choices – and how will financial markets react?

MORE UNCONVENTIONAL APPROACHES COMING



Source: Reuters EcoWin

The US Federal Reserve and other central banks are expected to launch more quantitative easing, while their room for traditional interest rate policy is more or less exhausted.

Monetary policy continuing to stimulate markets

Because of low growth and inflation, and in order to safeguard financial stability, central banks in the OECD countries will be pursuing monetary policies characterised by interest rates close to zero for a long time to come. In some cases this involves promises of historically low interest rates for lengthy periods, and in some cases further quantitative easing programmes. *Maintaining monetary policies that focus on sustaining the economy and the financial system will undoubtedly remain a positive force for financial markets.*

But by all indications, the most important factor in determining what will happen to the global economy and market risk appetite over the next few years will be the direction of the policies pursued in the euro zone, aimed at dealing with the fiscal crisis and ensuring that the euro project works better in the long term and that the euro will survive.

Crisis management being activated at several levels

Crisis management policies in the euro zone are now operating at several levels, with a focus on problem-plagued countries in southern Europe. Since last spring, a consensus has emerged that there is a limit to the amount of fiscal tightening countries can handle, and that these countries can be given more time to implement austerity measures promised as part of their national fiscal policies. For example, Spain received an additional year in which to reduce its budget deficit to a maximum of 3 percent of GDP.

One thing that has triggered feverish political activity centring on the European Central Bank (ECB) and the EFSF/ESM is the risk that additional problem countries in Europe (read: Spain and Italy) – just like Greece, Ireland and Portugal – will be hit by runaway government bond yields and thus cannot finance their budget deficits in the fixed income market. Another is the risk that acute financial problems might jeopardise the survival of the euro in its present form.

Is Draghi's medicine enough to stabilise the crisis?

The ECB previously bought euro zone government bonds in the secondary market as part of its Securities Market Programme (SMP). After its interest rate meeting in early August, ECB President Mario Draghi – against the strong objections of Germany's Bundesbank – announced that the ECB may again start buying euro zone government securities with short maturities in the secondary market, provided the countries in question have formally requested assistance from the EFSF/ESM bail-out funds. These funds would meanwhile start buying their bonds in the primary market (as part of these countries' bond issues). Such an arrangement means, in turn, that each country would be forced to submit to the required euro zone financial discipline, mainly the provisions of the EU "Fiscal Pact".

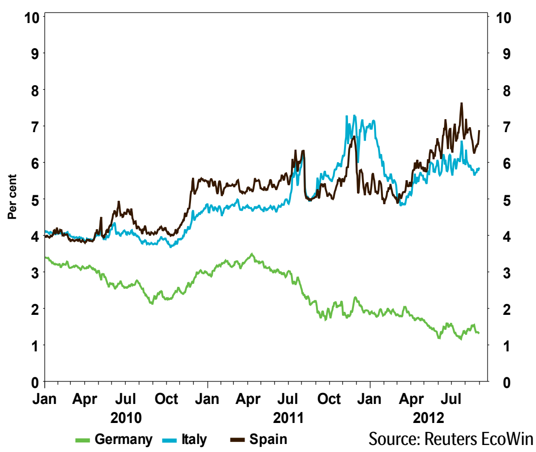
By all accounts, the reason why the ECB can only consider buying short-term government securities is that the bank can then argue that such an action falls within its traditional monetary policy mandate. It can thus avoid accusations of violating the ban on financing countries' budget deficits by printing money. At this writing, the details of the ECB's potential purchases of short-term government securities are not known, nor is the German Constitutional Court's ruling (due on September 12) on whether the ESM is compatible with the German constitution. Germany is likely to give the ESM the green light. Then the ECB and the bail-out funds could immediately begin their purchases of government securities, assuming that Spain and perhaps also Italy will have applied for assistance. *This would undoubtedly be a very important step forward in addressing the sovereign fiscal crisis, something that would be welcomed by financial markets.*

Even if such a political breakthrough is achieved, the question still remains whether this is enough to stabilise the European debt crisis in case other large euro zone countries also encountered acute financial difficulties. The EFSF and ESM bail-out funds may lend a total of EUR 700 billion. Nearly EUR 200 billion has already been used for Greece, Ireland and Portugal, and EUR 100 billion has been earmarked for Spain's banks.

One elegant solution – at least theoretically – would be to equip the ESM with a banking licence, which would allow the fund to borrow from the ECB while simultaneously issuing its own bonds in the fixed income market. This would enlarge the lending capacity of the ESM to around EUR 2.5 trillion. But the problem is that a banking licence for the ESM probably violates EU rules and that Germany is very strongly opposed to such an arrangement. Another possible approach that Germany – and especially the Bundesbank – also objects to is for the ECB to establish a ceiling on spreads between the government bond yields of problem-plagued countries and those of Germany, which in principle could open the way for unlimited bond purchases by the ECB. This would also represent a drastic departure from the ECB´s earlier restrictiveness about purchases of financial assets.

In any case, valuable and important political steps have been taken this past summer to deal with the sovereign debt crisis, and if implemented they may bring about a medium-term stabilisation of the euro zone situation. Stabilisation would be welcomed by financial markets, although to some extent such an outcome may already have been discounted.

THE GOAL IS TO NARROW THE YIELD GAP



One central objective of euro zone crisis management policy is to reduce yield spreads between 10-year sovereign bonds (see chart) of problem-plagued countries and Germany.

Policies to ensure euro zone survival revving up

Meanwhile there are still major long-term doubts about the euro project and the future of the common currency. Given the current time perspective, popular support for deeper economic, financial and political cooperation is crucial. But the task of winning this support will not be easy, given the poor health that currently characterises both private and public finances in the euro zone.

At their June 28-29 summit, the euro zone countries reached agreement on the introduction of a banking union – a requirement if the EFSF/ESM is to lend money directly to a country's banks without going via government budgets – which among other things would involve the creation a joint bank supervisory mechanism and a deposit guarantee scheme. The details of this financial union will be presented by the European Commission on September 11, and there are hopes that the plan can be adopted at the EU summit on December 13-14 and, if so, probably go into effect in January 2013.

Roadmap for a genuine economic and monetary union

The banking union is part of the roadmap for a genuine economic and monetary union (a "new EMU") which also consists of three more building blocks: a fiscal union, an economic policy union and a democratic union. The ultimate purpose of the roadmap is to lay the groundwork for the long-term survival of the EMU and the euro. It undoubtedly also creates a good platform for continued political discussions.

The roadmap project is headed by four key political figures in the EU – Van Rompuy, Barroso, Juncker and Draghi. An interim report is due by mid-October, and the documentation needed for decision-making should be ready by the EU summit in December.

Efforts to redraw the EMU map will thus occur at a rapid pace. This is likely to contribute to impassioned political discourse and numerous open controversies this autumn – something that financial markets can hardly ignore.

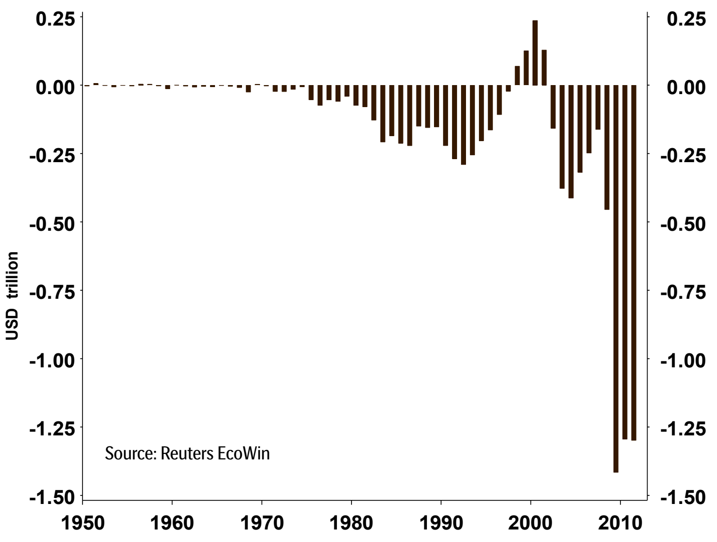
The fiscal cliff in Washington

Another potential political drama with great power to shake financial markets is looming on the other side of the Atlantic. This is because the U.S. faces a federal budgetary precipice at the beginning of 2013. Leaping over the edge of this cliff would mean tightening fiscal policy by some USD 600 billion, equivalent to about 4 percent of GDP. The reason is that if Washington political leaders fail to agree on a budget before December 31, there will be a huge reduction in defence spending, the Bush administration's temporary tax cuts as well as President Obama's temporary payroll tax cut will expire and significant automatic spending cuts will take effect in a variety of areas. Such a fiscal cold shower would almost certainly plunge the US into a recession in early 2013 (since its contractive effect would be greatest at that time).

Decisions and concessions needed to avoid the cliff

To prevent this and to ease fiscal tightening, the U.S. Congress must make active decisions and both Democrats and Republicans must make concessions. This is also likely to happen, though the political situation is very uncertain and a complex negotiating process lies ahead. Our main scenario is that most of the temporary tax cuts will be extended and some automatic cuts will be accepted. This would limit fiscal tightening to 1 per cent of GDP in 2013.

Our forecast is based on the assumption that Barack Obama is re-elected president. If this proves wrong and the election is instead won by Mitt Romney, there is a risk that the dose of austerity will be larger. This is because Romney's running mate Paul Ryan has previously submitted proposals to slash the federal budget deficit at a significantly faster pace. It is thus not out of the question that financial markets would be happier with Obama in the White House than with Romney.



MODERATE BUDGET AUSTERITY, OR WHAT?

The fact that the US federal budget deficit (chart) needs to be reduced by means of fiscal austerity is hardly controversial, but right now there is great uncertainty about how large the dose of austerity should be. A compromise between Democrats and Republicans would probably mean moderate belt-tightening, while a lack of decisions and political concessions would mean a large dose and an accompanying recession early in 2013.

OECD tightening continues at a steady pace...

With fiscal tightening in the US next year and significant budget austerity in the UK, Japan and the euro zone, our calculations show that the OECD countries as a whole will feel a dose of austerity around 1 percent of GDP in 2013. This is about the same magnitude as in 2011 and 2012.

The overall budget deficit of the OECD countries would thus shrink to just over 4 percent of GDP next year. While this is certainly a substantial reduction compared to a few years ago, fiscal policy must still remain contractive for years to come, which will hamper growth in these industrialised countries.

...while emerging markets have room for stimulus

While there is thus little room for fiscal stimulus in most OECD countries, there are opportunities for such actions in much of the emerging market (EM) sphere. EM countries also have plenty of monetary policy manoeuvring room.

Over the past year China – a key country for both the world economy and global financial market events – has activated its monetary policy more than expected, cutting both key interest rates and reserve requirements for banks. We also expect further monetary easing by means of both these instruments this autumn and winter.

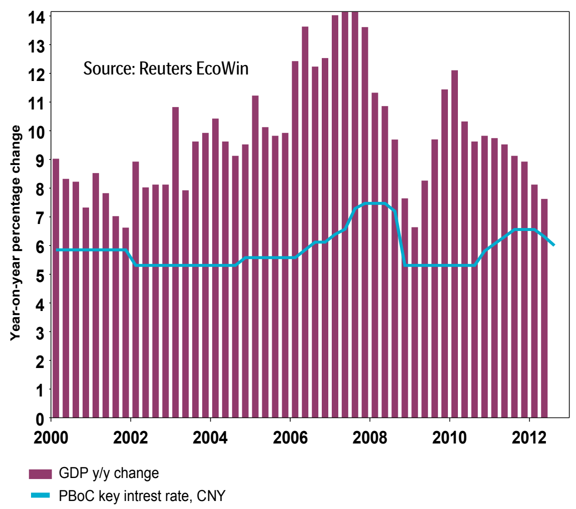
China's public finances are in good shape, with a budget deficit of only about 1.5 per cent of GDP this year. The country thus also has good potential to pursue an expansionary fiscal policy. However, it is unlikely that these measures will be of the same magnitude (7 per cent of GDP) as during the global financial and economic crisis of 2008-2009. One reason is that this time around, Chinese GDP has not decelerated as sharply and that the global economy is not in nearly as bad shape as last time. Another reason is that a large portion of the Communist Party leadership will be replaced this autumn, and such events usually hold back the launching of major new reforms.

During the next few quarters, China will nevertheless stimulate its economy with fairly large doses of both monetary and fiscal policy measures and is therefore likely to avoid a cyclical hard landing.

Conclusion: Looking ahead, economic policy measures can certainly be more help than hindrance.

The overall outlook for economic policy now seems brighter than before. In the euro zone, a number of important steps will apparently be taken, which may help stabilise the medium-term fiscal situation. Efforts to ensure the long-term survival of the currency union and the euro are now gaining speed. In the US it seems increasingly likely that a fiscal cold shower can be avoided this coming year and federal budget tightening will be on a reasonable scale. In China there is room to stimulate the economy through both monetary and fiscal policy, so the potential to avoid an economic hard landing seems good.

In terms of economic activity and risk appetite, the risk outlook mainly includes possible negative economic policy surprises such as 1) increased tensions, political failures and signs of euro zone collapse in Europe, 2) political failure to reach a US budget agreement, thus throwing the economy over the fiscal cliff and 3) unexpectedly small and/or ineffective economic policy measures in China, leading to a continued slowdown in the Chinese economy.



CHINESE RATE CUTS WILL END GROWTH SLOWDOWN

Since its peak in early 2010, GDP growth in China has gradually decelerated to 7.6 per cent in the second quarter of this year. In response, the People's Bank of China has taken such steps as cutting its key interest rate several times, and we forecast additional rate cuts. Along with lower reserve requirements for Chinese banks and a slight dose of fiscal stimulus over the next six months, this should be enough to prevent an economic hard landing and lay the groundwork for somewhat faster growth late in 2012.

The credit market – complex and attractive

This article is an introduction to the part of the capital market that consists of fixed income securities, i.e. the credit market. We will introduce market participants and explain the pricing of the various products. We will describe how trading takes place, discuss the most common risks and explain the most common concepts occurring in the credit market.

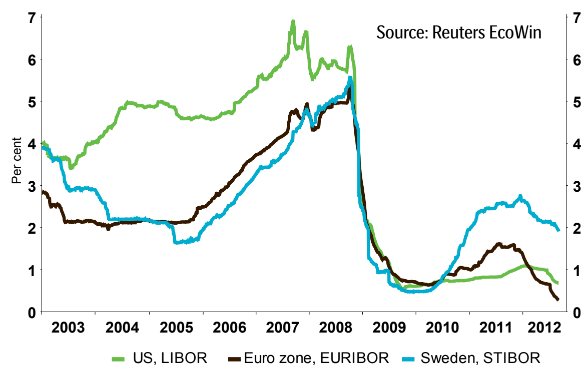
As we know, the stock market supplies equity. The credit market emerged as a complement to the stock market to meet the need for debt financing. The needs of the lending market were initially covered mainly by banks that lent money directly to borrowers. The market grew, evolving into one where borrowers were helped by banks or similar institutions to create bonds or other debt securities. This is also the credit market's primary mission – allocating assets between borrowers seeking capital and investors who have surplus capital.

The credit market is divided into the money market and the bond market. Securities issued with a maturity (due date) of less than one year belong to the money market. Those issued with longer maturities are called bonds (those with maturities of 1-10 years may also be called "notes"). The bond market includes maturities of 1-30 years and even longer.

STIBOR, LIBOR, EURIBOR

These three concepts have the same function, but in different currencies. STIBOR (Stockholm Interbank Offered Rates) refers to Swedish kronor, LIBOR is denominated in US dollars (USD) or British pounds (GBP), while EURIBOR is used in the euro (EUR) zone. The banks that deal directly with each country's central bank show the interest rate at which they will lend money to each other. These interest rates are fixed around noon each banking day by the respective central banks and apply until the next banking day. But obviously a three-month "STIBOR fixing" is valid for the next three months. The time periods commonly fixed can range from one week to one year. The most important is the three-month period. The reason is that most borrowers that pay variable (floating) interest rates are fully exposed to this particular period. Floating rate notes (FRNs) are also directly affected by the interest rate that Sweden's Riksbank sets every day.

CONTROLLING THE FLOATING INTEREST RATE



The above chart clearly shows that cuts in central bank key interest rates have impacted three-month rates. As the chart indicates, Sweden's Riksbank has not needed to stimulate the economy to the same extent as the European Central Bank, for example, and STIBOR is thus clearly higher than comparable rates.

The players in the credit market

The market consists of borrowers such as mortgage institutions and those who buy the securities they issue: lenders or investors. These two market players are fundamental, but without a third party to ensure that these interest groups get together, it is difficult for them to find each other easily and cheaply. This is why an intermediary function between the two groups has emerged. These intermediaries – usually banks, brokerage houses or individual brokers – are organised into three groups. One of these is in daily contact with borrowers. A second group is in contact with investors. A third group is tasked with bringing the interests of these two together. In addition, they are supposed to document the volume of buyer interest and which customer segments are interested. This information is then published on Reuters and Bloomberg, for example.

If a government issues bonds, each intermediary has undertaken to set prices and serve as a marketplace. The price or yield at which bonds are issued is determined on the basis of buyer interest in the market at that particular moment.

The corporate bond market is based solely on the needs of the borrower. This may involve a lengthy process from start to finish – a process that includes weighing choices of maturities, issue size, the type of instruments that is most effective and what channel to use. Should we ask the bank for a loan? Who, or what intermediaries, should receive an opportunity to launch this loan in the credit market?

A borrower's thoughts and an intermediary's responses

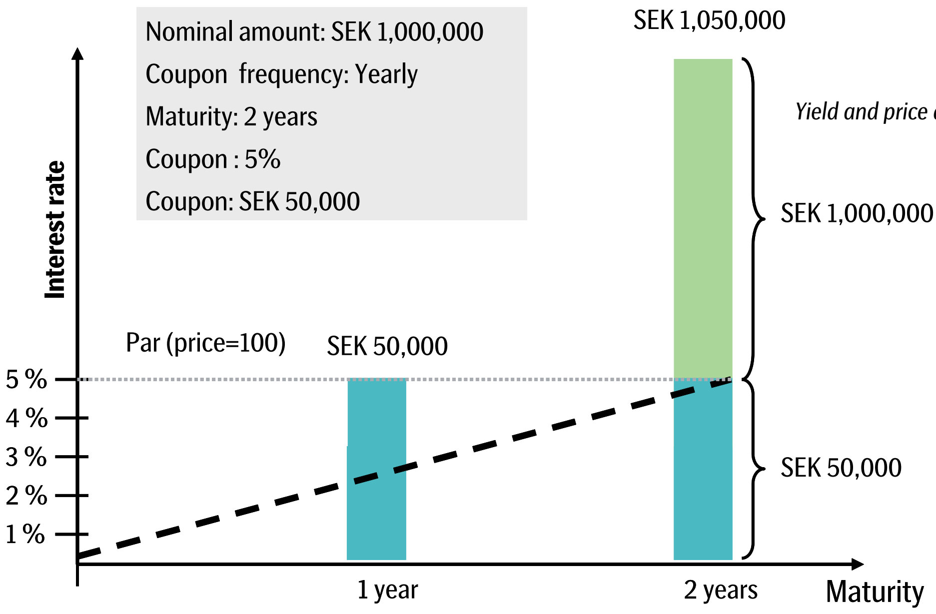
The necessary time to maturity is determined partly by when the borrowing entity believes it will have enough cash to pay back the bond amount on the due date. Then there are certain time intervals that are cheaper than others for issuing bonds. How do you decide a level that is reasonable? What tools are available? Does anyone have a rating similar or identical to the borrower, and at what yields did they issue bonds? What should the minimum purchase be – SEK 100,000 or SEK 1 million? In some cases this may be relevant in order to ensure good liquidity for the bond issue.

Presentation to prospective buyers is important

Once the terms and conditions have been established, the bond issue must be presented to various bond purchasers. This is done through telephone contacts or by having someone who represents the issuer presents it to investors. This includes describing the issuer's operations in detail, reviewing its debt situation and also trying to forecast the future of the company or the industry in which the borrower operates.

The most important assessment that a bond purchaser must make is whether there is any possibility that he may not receive the promised coupon income and that there will be problems with repayment of the nominal loan amount. Soon afterward (rarely longer than a week) the new issue takes place. All bonds are assigned an ISIN code, unique to each bond. These securities are ordinarily listed on a well-known stock market (OMX or similar). There are investors whose rules require that their holdings be publicly listed. Publicly listed securities are not the same as publicly traded ones, however. In some cases, the market player

FOLLOWING A BOND FROM ISSUANCE TO MATURITY



Source: SEB

In most cases, a fixed-coupon bond has a price that is 100 on the issue date ("Par" in the chart), since the coupon has been set at the level shown in the yield curve (grey line). The price refers to the amount to be paid; thus the investment on the issue date, totalling a nominal SEK 1 million, will coincide exactly with the payment amount, SEK 1 million. After six months, the bond's time to maturity has decreased to 1.5 years, and as we see in the chart, the swap curve (dotted) is slightly positive. Investors demand higher yield to commit their money for a long period. The bond is also priced at another point along the swap curve, the 1.5 year point, and the yield and coupon rate are different. The yield is lower, while the coupon rate is constant during the life of the bond. Lower yield = higher price. The bond is traded at a premium.

that issued the bond may keep a small portion of the bonds in its own inventory. The reason is that some interested buyers were absent when the issue took place. They are offered a chance to buy the bonds later. The banks that organised the bond issue then set prices for both buying and selling the bonds, thereby creating a market for this security.

Bonds with both fixed and variable (floating rate) coupons are priced at the same spread, provided that they have the same issuer and maturity. But they are priced against different bases, either using, for exemple, 3-month STIBOR or against the level that the swap curve shows. One alternative comparison might be to see where on the curve a government bond with the same maturity is priced. Most of the bonds that are issued are of the fixed coupon type. In the case of a floating rate loan whose rate is re-set every three months during its 2-year maturity, the rate is determined by the level at which 3-month STIBOR is quoted. If the issuer wants a shorter refixing period for both principal and interest (for example, to meet temporary liquidity needs), it may issue commercial paper that falls due after perhaps three months. This commercial paper is priced on the basis of where 3-month STIBOR has been fixed.

A swap, or interest rate swap (IRS), is a "derivative instrument". Swaps were originally used to exchange fixed interest flows for variable one, or to turn variable coupon flows into fixed ones.

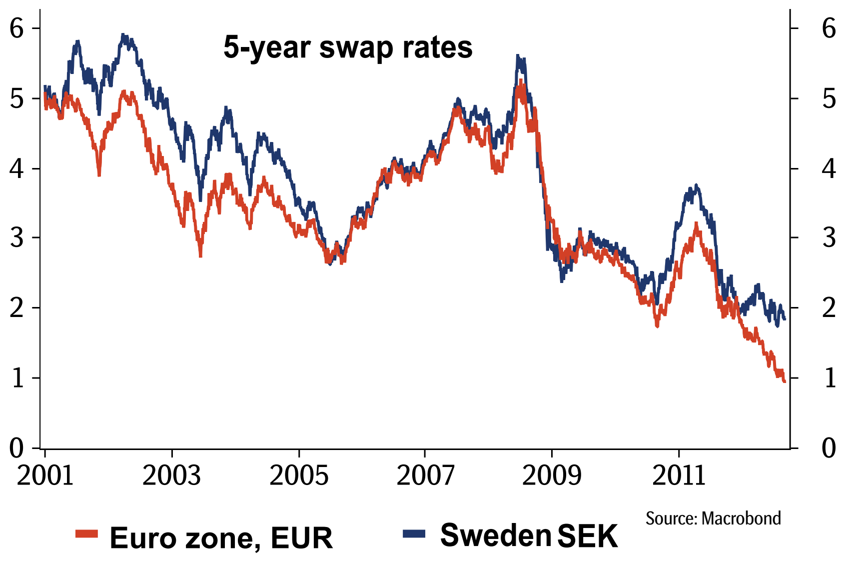
EXAMPLE:

For a mortgage institution, the proportion of customers who pay variable rates has increased significantly compared to 15 years ago. Many investors want to have fixed coupons, for reasons of simplicity but also reasons of liquidity and duration. Here we have conflicting interests.

So the mortgage institution issues its fixed-coupon bond and at the same time carries out a swap transaction that adjusts its cash flows to actual events. The mortgage institution receives interest payments from its clients, who are borrowers, and the payments are transferred onward to the bank that organised the swap.

The bank that organised the swap pays the fixed coupon, which is delivered to the bond investor. In this way, the mortgage institution has eliminated both interest rate risk and liquidity risk, and all cash flows are matched. If more borrowers want a fixed interest rate, the mortgage institution terminates the swap.

PRICING SHOWS A FALLING YIELD TREND



Source: Macrobond

In the past 10 years, interest rate swaps have fallen by 4 percentage points in the euro zone and by 3 points in Sweden – further evidence of the falling yield trend.

All kinds of risks

Price risk (interest rate risk) occurs in a situation where the value of a bond is adversely affected, for example because general interest rates rise. In that case, the value of the asset falls. The yield rises when the price falls. What is usually measured is how much the change in value will be when interest rates rise by one percentage point. Price risk is partly related to maturity, but also how high a coupon is paid every year. We can also say that the bond's effective duration is shorter. Furthermore, we must consider how often coupons are received – annually or every three months? Interest rate risk is reduced if the coupon is received and adjusted according to the movements of 3-month STIBOR. The third factor is that the interest rate itself has an impact on interest rate risk. Low interest rates mean higher interest rate risk.

Liquidity risk

Liquidity risk is the threat that no one wants to buy our bond, or that transaction costs will rise to uneconomic levels. One event that occurred relatively recently is the Lehman Brothers crash (autumn 2008), which drained the market of liquidity. Banks refused to provide liquidity and dared not lend to each other.

From an investor's perspective:

Liquidity risk is a risk that can quickly change over time. One assessment that investors should make is what potential they have to sell their bonds. Does the issuing institution have its own inventory or are investors dependent on the skilled brokers working for a small market player?

An environment of high liquidity risk is also characterised by higher transaction costs, which risk making it impossible to sell the securities at a price close to their market value. Usually markets where there are large volumes of certain loans, such as government and mortgage bond markets, are considered the most liquid.

The corporate bond market is a little special in this context, since large volumes are issued but demand also is high, occasionally creating shortages of securities in the secondary market. Investors dare not sell without knowing that the proceeds can be reinvested in other securities.

Credit risk

Credit risk is usually tied to a specific borrower or issuer. This type of risk includes everything from individual countries to specific legal entities. But of course, a whole market may be affected if credit risk should increase. Big home price declines may cause the entire supply of outstanding mortgage bonds to fall in value.

From an investor's perspective:

Credit risk simply refers to the risk that investors will not receive their coupons during the life of the loan and the principal amount and last coupon on the due date. A bond investor is normally sceptical towards a borrower that has extravagant investment plans or prioritises high dividends that may jeopardise his intended cash flows.

Credit risk also arises from time to time in the case of individual countries, like Greece. Regulatory requirements for banks to strengthen their balance sheets are based on their need to manage credit risk in particular.

In order to assess the credit risk of an issuer, there are market participants that focus on assessing these; they are called rating agencies. The three most widely used are Moody's, Standard & Poor's and Fitch. They analyse issuers and "rate" them according to different scales. They mainly evaluate the extent of the risk that the issuer cannot repay coupons and the principal amount on the due date.

The rating agencies' analyses and conclusions are used by large bond purchasers to determine how much they can invest at the various rating levels, such as "unlimited at AAA" (S&P rating). Others may have a minimum level as to how low they are willing to go (how great a risk they may take). Here investment grade, (a rating of BBB- or higher) is a common minimum. The level below investment grade is called high yield.

The various credit market instruments

There are two main types of instruments: bonds with fixed coupons and bonds with variable coupons, known as floating rate notes (FRN). The largest volumes of bonds are issued with fixed coupons. For example, the Swedish government has never issued any bonds without fixed coupons. However, FRNs are very common in the corporate bond market. If BMW needs capital, for example, it usually offers both fixed and variable (floating) coupons.

Floating rate notes are priced on the basis of a 3-month STIBOR fixing two days before it rolls into the next 3-month period. It is therefore difficult to estimate future cash flows. Among major buyers of this type of securities are money market funds and liquidity funds. The issuers include mortgage financing companies, real estate companies and automakers.

Cash flow on a fixed-coupon bond is possible to calculate, however. We assume that the effective yield is identical throughout the life of the bond. This means that we reinvest the annual coupons at the yield we receive when we bought the bond. We discount all cash flows or coupons at the same yield.

Pricing varies between different securities, depending on who the issuer is and what economic sector they operate in, but the credit rating that rating agencies have given a borrower is also important.

EXAMPLE:

Volvo, a globally leading truck and heavy equipment manufacturer, has been rated by Standard & Poor's as "BBB stable outlook". Its bonds are priced at around +110 to interest rate swap. If we compare this with Scania, which is in the same sector, the level for Scania would end up at +80, with one explanation being that Scania has been rated at "A- stable outlook" by the same agency. Whether it is reasonable or not that over a three-year period it costs Volvo nearly 1 million more to borrow SEK 100 million is a question that investors must assess.

If a company has genuinely uncertain prospects and also finds itself in an intensely competitive environment, the premium may end up at levels above 1000.

One example of this is the Scandinavian Airlines System (SAS), despite its stable ownership structure (the Swedish government owns 21.4 per cent and the Danish and Norwegian governments 14.4 per cent each). Here we need to mention limitations on ownership, also known as a change-of-control (CoC) clause. In the case of SAS, it specifically applies to a bond maturing in 2014 and means that government ownership must not drop below 25 percent, or a new shareholder must not own more than 50 percent. If this occurs, SAS must buy back the bond at a price of 100 (par).

Building up a credit market portfolio

The number of issuers in a credit market portfolio depends on how much risk we want to take. Even if investors are willing to take on higher credit risk and liquidity risk in order to receive a higher return, their portfolios should be diversified. This means that they should hold securities from a number of issuers and should not have too much exposure to the same sector or excessive exposure to the same maturity. A good portfolio structure can be summarised this way: the higher the risk, the more bonds from different issuers and preferably different maturity periods an investor should have.

Interest rate risk increases in case of longer maturity and low yield curves. At present, interest rates are generally low and interest rate risk is thus high. Coupon size is also important, since a low coupon means a high interest rate risk. If we buy a bond with a fixed coupon, we discount future annual cash flows at the effective interest rate on the purchase date. If interest rates then rise by one percentage point, the cash flows furthest away in time are the ones most affected by the increase in the discount rate.

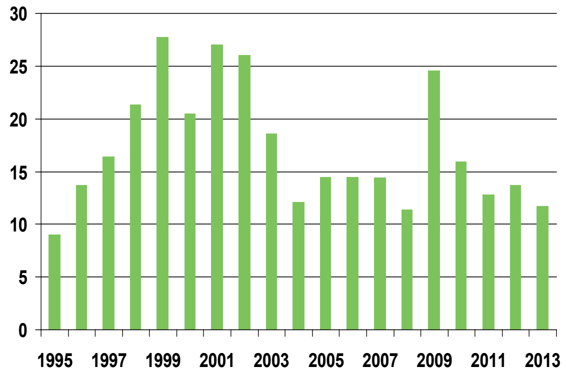
There are many opportunities in the credit market. Please contact your private banker to discuss how best to take advantage of these in your portfolio.

Genuine investments

- *Buy when it feels unpleasant*
- *Valuations are attractive*
- *Oil services are appealing*

Second-quarter reports for Nordic listed companies contained as many upside as downside surprises. Overall, profits were slightly lower than consensus forecasts, and we have adjusted our profit forecasts downward by 5 per cent for 2012 and 3 per cent for 2013. On the whole, profits are expected to rise 4 per cent this year (but will fall 9 per cent in Sweden) and 16 per cent in 2013. Despite the euro zone crisis, listed companies are well on their way to posting record earnings this year.

EQUITIES GENERATING RETURNS



Source: SEB Enskilda

The chart shows net income for Nordic listed companies as a percentage of their market value, that is, the return companies generate for their shareholders (also called the inverted P/E ratio).

Despite record corporate profits, the stock market index is on par with December 2000 and summer 2006 but 25 per cent below top levels in 2007. The combination of high profits and low share prices means that equities are attractively priced. We expect total profit for this year equivalent to 7.4 per cent of market capitalisation in the Nordic countries.

Equities are one asset class that is still generating a substantial return for shareholders (not to be confused with their historical total return). Equities are risky assets whose future pricing is uncertain, but they also generate a return for shareholders so they are not simply speculative investments based on expectations of future price movements (in absolute or relative terms). In recent years, this quality has been increasingly unusual given the dramatic decrease in return requirements for assets with traditionally lower risk.

Dividends are good, reinvestment better

The profits a company generates for its shareholders can either be distributed directly as dividends or retained in the company. We expect a dividend yield on Nordic equities of 4.0 per cent in 2012, which means that companies are retaining just under half of their reported earnings. Funds retained by companies can be used either to reinvest in operations for future growth or strengthen their balance sheet.

In recent years, there has been far greater interest in dividend yields, in part due to low interest rates. We share the view that a 4 per cent dividend yield helps make equities an attractive investment alternative in the Nordic countries, but it is more important to look at the profits companies generate than the dividends they pay out.

A strong balance sheet reduces equity risk and thus has a value for shareholders, at least if the company is not already overcapitalised. However, usually the best alternative for shareholders in the long term is to reinvest profits in operations, given that the return on equity is averaging 12.5 per cent in the Nordic countries this year, a level of return that is difficult to match in today's financial markets.

Buy growth industries

One essential requirement to enable companies to find attractive reinvestment alternatives for their earnings is often that their market is growing. One sector where growth is expected to be particularly good over the next few years is oil services, that is, suppliers to the oil industry.

This was reinforced by quarterly reports from Norwegian oil service companies in particular, with their many upside surprises. The biggest supplier of offshore products on the Oslo stock exchange reported 61 per cent growth in order bookings, equivalent to 193 per cent of sales for the quarter, as well as improved margins. The largest underwater engineering company indicated it expected better margins going forward, with a near-record order backlog expected to increase further during the second half of the year. Seismic services companies meanwhile foresee the strongest, fastest improvement in the market since the 2005-2008 boom.

Bright propects for oil services

Currently producing oil fields around the globe will gradually be depleted, and in 15 years production will be half the current level. Meanwhile, vehicle volumes in Asia and other emerging markets are growing steadily, which guarantees a constant or growing thirst for oil around the world. To replace the old oil wells that are now being depleted, oil companies are forced to invest ever more capital since new discoveries are often located in places that are harder to reach, for instance, in stormy deep sea waters.

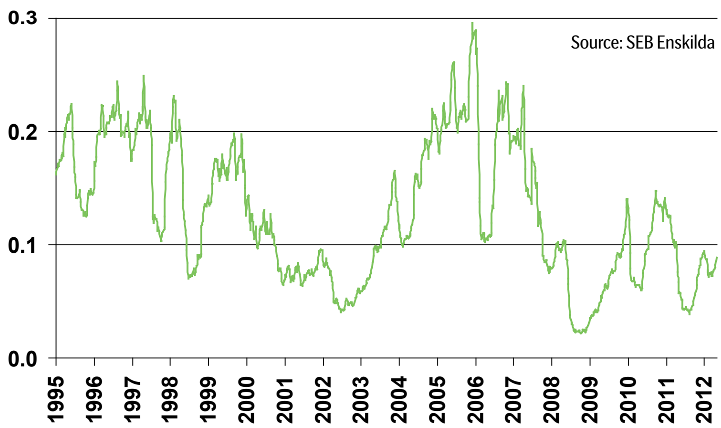
Private oil companies have boosted their capital spending by 12 per cent or more every year over the past decade, except in 2009. According to our latest survey, private oil companies are planning to increase their spending by 13 per cent this year and 3 per cent next year, while nationally owned oil companies are planning capital spending increases of 12 per cent this year and 8 per cent in 2013. They are most likely once again underestimating their investment needs for next year, partly for tactical reasons. As a result, we expect revenue growth for Nordic oil service companies of 18 per cent this year and 13 per cent in 2013. Earnings growth will be even better; we expect 38 per cent this year and 31 per cent in 2013. Despite these bright prospects, the industry is valued at a price/earnings (P/E) ratio of 12.3 based on our forecasts for the current year, a 9 per cent discount compared to the average for Nordic equities. Dividend yield is 5.0 per cent, which is more than the average in the Nordic countries despite good access to expansion investments for companies. We find the combination of good growth and valuations that are even lower than the stock market average very attractive.

Buy when the market is really worried

Since hitting lows this summer, the OMX Stockholm stock exchange has risen 10 per cent, while the MSCI Nordic Index is up almost 20 per cent. At the same time, market jitters have eased considerably.

In a short-term perspective, we find the rebound to have been rather rapid and see a clear risk of a market correction. Investors should focus primarily on valuations, but in order to optimise their timing in buying shares, they need to supplement this with an assessment of their risk aversion. The ideal time to buy is when the market is at its most nervous and buying shares feels unpleasant. Below is an example of an index that combines valuations with risk aversion.

Risk-adjusted valuations are still low, but no longer extreme, which points toward a more subdued market for the rest of the year than we have seen over the past two months.



RISK-ADJUSTED VALUATIONS HAVE INCREASED

The chart shows an example of risk-adjusted valuations for the MSCI Nordic Index calculated as equity divided by 90 days of historical volatility in share prices.

Turbulent risk sentiment

- *US shares at 4-year high, China's at 3-year low*
- *Prices up despite lower profit forecasts*
- *High expectations, great uncertainty*

The year started out with sharply higher share prices. This increased risk appetite was the result of measures implemented by the European Central Bank (ECB) late last year in an attempt to resolve the euro zone crisis. After initially having the desired effect the works got gummed up, as often in the past, when problems in southern Europe intensified during the spring.

Alongside the troubles in southern Europe, during the spring global macroeconomic statistics began to weaken. The problems in the euro zone, combined with global economic deceleration, left their mark on global equity strategies. Recommendations at an aggregate level were for the lowest exposure to equities since the sub-prime crisis and the Lehman Brothers collapse.

After a cautious start to the summer, market sentiment once again shifted, kicking off a new upswing on the world's stock exchanges over the summer. The driving forces behind the latest increase in investor appetite were slightly better macroeconomic statistics and lower recession risk, but above all hopes of further stimulus from the US Federal Reserve and ECB.

Soft macro statistics but the US stands out

Many macro statistics in 2012 have been worryingly weak. Hopes of more stimulus may not seem so strange in light of reality. A look at the world's producing and exporting countries suggests a clear deceleration in economic activity. The major difference compared to the past is that this time around it is not just individual countries that have had problems. This time it is largely a global slowdown.

The deceleration has been clearest in Europe and China. In the US, the picture is somewhat mixed, but generally more positive and more stable than elsewhere. The difference in the economic performance of various countries and regions is perhaps best reflected in the US S&P 500 share index, which is at or near a four-year high, while China's Shanghai Composite is at a three-year low.

The US stands out at the moment as one of the few positive examples. Meanwhile growth is historically low; combined with four-year near-highs for US share indices, the upside seems fairly limited. There is an imminent risk that the rest of the world's problems will ultimately affect the US as well.

Europe – the market's problem child

Europe remains the biggest problem area, and the trend there has been consistently rather negative. As before, the problems are worst in the south. Slumping growth and rising unemployment are telling examples. Euro zone heavyweights like Spain and Italy are also having difficulty getting access to the credit market (problems borrowing on reasonable terms).

The generally weak euro has provided support for European manufacturers and exporters, and the biggest winner from the euro's depreciation has no doubt been Germany. The euro zone is very much a two-speed story; the gap between the top (Germany) and bottom (Greece, Spain) just keeps growing, both in real economic terms and stock market trends.

In Europe, expectations are for continued structural measures, continued austerity and generally subdued economic activity. The "problem" GIIPS countries – Greece, Ireland, Italy, Portugal and Spain – represent only 5 per cent of the world's GDP but as much as 25 per cent of the European Union's GDP. We have known for several years now that as long as the sovereign debt problems are not resolved but instead always put off to the future, the crises will recur with growing frequency. The question persists whether Greece will remain in the currency union, and there is still a significant risk of negative contagious effects in the event of an exit. Spain is another storm cloud on the horizon, and the trend there is anything but positive. The risk of investing in European equities must still be considered high.

Emerging markets: downside surprises for BRICs

In earlier crises, the world could rely on things going well for the BRICs (Brazil, Russia, India and China), large countries with economies that impact the global economy. As a group, these countries too have now been hit by the economic slowdown. Growth is generally high in absolute terms but not good enough to provide much-needed support to the rest of the world, and not enough for the economic wheels to spin as fast as they have in recent years. The trend in the BRIC countries, especially China, has perhaps been the biggest downside surprise in 2012. The magnitude of China's deceleration has surprised many.

As in China and Brazil, the economic trend in India has flagged considerably. India is suffering from high inflation, and indications from the central bank are that fighting inflation now has a higher priority than measures to promote growth. The Russian economy is closely linked to oil and oil prices, yet despite recent turbulence and oil price volatility, this economy appears to be stable.

Emerging markets still stand out as an attractive investment, with countries and regions that are growing on their own, often with a large domestic market that is not directly linked to problem areas like Europe. Price trends for different emerging market share indices have not given the market much to celebrate. From a risk/reward perspective, it seems that many negative factors have already been priced in. Emerging market equities are also trading at a 17 per cent valuation discount (P/E) against the developed markets.

Revised forecasts and impact on valuations

As macro statistics have weakened, global GDP forecasts have been revised downward. Our current forecast is around 3.3 per cent for 2012. This level is low in historical terms but still indicates a climate in which it has historically paid to own equities.

The recently ended reporting period in the US showed that companies fell shortest in meeting analysts' consensus expectations since 2009. Combined with rather subdued economic forecasts from the companies themselves, this has led to equity analysts revising their forecasts downward (as much as 50 per cent of production, sales and earnings of listed companies in the S&P 500 come from "the rest of the world"). Contrary to expectations, share prices have risen during this period of downward revisions. What drives stock markets historically are phases of upward and downward revisions, but usually with the opposite effect. In a historical perspective, it should be noted that we are still far from levels at which valuations can be considered strained or extreme, but when earnings forecasts fall and stock prices rise at the same time, this has a negative effect on valuations. Equities do not look as attractive as they did earlier in the spring. Share prices are higher relative to expected future earnings (higher P/E ratio).

Investment climate offers challenges

The general economic trend has shown a slight improvement recently and the risk of a recession has been revised downward, but by far the biggest driving force behind the gains in share prices is hopes that the world's central banks will once again provide necessary stimulus to the global economy.

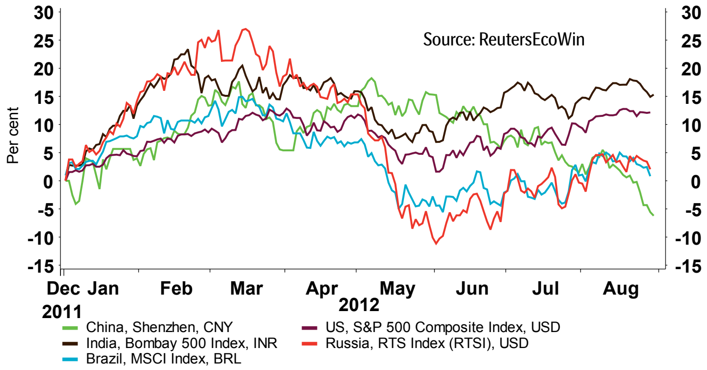
The investment climate in 2012 is and has been challenging, to say the least. The importance of expected central bank measures has trumped basic fundamentals. In a short-term perspective, it is often no problem when the market follows its own course, but in a longer-term perspective, sooner or later there will be an adjustment to reality with fundamentals taking the upper hand.

High expectations and great uncertainty

Historically, a good strategy has proven to be buying when things look darkest and selling when everyone is buying. In sheer macro terms, things do look dark. With some stock exchange indices near four-year highs, one could draw the conclusion that pessimism is probably not nearly as widespread as is often believed.

After a period of steady share price increases and low volatility, we are most likely facing a period of higher volatility and thus higher risk. This autumn will show whether the market gets what it wants in the form of more stimulus. Being selective and focusing on good risk management is a challenge to investors who want to take advantage of the potential nonetheless offered by global equities.

GREAT VARIATION IN STOCK MARKET PERFORMANCE



The loser from a five-year perspective and for the past year: Mainland China; at the other end, the US and Germany. From a long-term perspective, some BRIC countries have performed well (India, Brazil), but after a good start in 2012 the mood has grown more sombre.

Central banks acting more unconventionally

- *Slow growth and low inflation taking central bankers further down an unconventional path*
- *Several reasons why sovereign bond yields should rise*
- *High yield corporate bonds still the most attractive fixed income investment, but keep an eye on total portfolio risk*

The current economic situation and prospects for growth and inflation are among key factors determining what will happen in the fixed income market. History shows that slow growth and low inflation usually lead to low or falling interest rates, while a combination of rapid growth and high inflation usually means high or rising interest rates.

Growth around the world in general and in the industrialised countries of the OECD in particular is expected to be modest over the next few years, although the rate could potentially accelerate more substantially in 2014 (see the "Macro summary" chapter). But what happens then with inflation and inflation expectations – two factors that are particularly important in determining what happens in the fixed income market.

Inflation around the world has fallen over the past year, and our forecast is that the rate will drop further in 2013-2014, to about 1.5 per cent annually in the OECD countries. Among the underlying factors are continued low capacity utilisation (which keeps wage increases down) and a fairly stable trend for commodity prices. Granted, this summer's rising food prices will push up inflation somewhat in the short term, but the effect will still be rather limited, and a return to more normal weather patterns this autumn should bring food prices back down. This scenario of low, steady inflation is also reflected in pricing in the inflation-linked bond market, which shows long-term inflation expectations of about 2 per cent. Stable inflation expectations in turn have been a prerequisite for the exceptionally accommodative monetary policies of central banks in recent years, which together have paved the way for record-low government bond yields in many countries.

Conventional monetary policy – with central banks mostly raising and lowering key interest rates – has reached the end of the road in many places. However, unconventional monetary policy – with central banks purchasing government, real estate and corporate bonds, setting ceilings for bond yields etc. – appears to have a long future in store. Major steps have already been taken along this unconventional path, as reflected in a composite of balance sheets for the US Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of England (BoE) since 2007 – when the financial storms started brewing in earnest – which surged 150 per cent to about USD 18.5 trillion. And there are essentially no limits to this policy from here on out.

By all accounts, the Fed will combine its promise to extend the period of exceptionally low interest rates on its benchmark Fed funds (currently from autumn of 2014 to 2015) with the launch of a third round of quantitative easing (QE3) through substantial bond purchases in the second half of 2012.

The ECB, which has more leeway to cut interest rates than the Fed, is expected to lower its refi rate from 0.75 to 0.50 per cent in October this year and may also decide to expand its purchases of government securities in the secondary market. Assuming that Spain – and perhaps Italy – will soon formally apply for loans from the European Financial Stability Facility (EFSF)/European Stability Mechanism (ESM) emergency rescue funds (a condition set by the ECB), the ECB should be able to start buying their bonds in early autumn. However, in order for the ESM to begin operations, the German Federal Constitutional Court must give its approval at a meeting on September 12.

Bank of England raises bond purchase ceiling

In addition, this summer the BoE raised its ceiling on bond purchases to GBP 375 billion, and we predict that this ceiling will be raised by a further GBP 50 billion during the fourth quarter this year. The Bank of Japan (BoJ) will probably also expand its quantitative easing measures this autumn, which may include purchases of both bonds and equities.

Sweden's Riksbank and Norway's Norges Bank are among the central banks still following the conventional path, with interest rate policy being their foremost weapon. Our forecast is that the Riksbank will lower its repo rate (currently 1.50 per cent) to 1.00 per cent by the end of 2012, while Norges Bank will take its key interest rate (currently 1.5 per cent) in the opposite direction, in three rounds of increases to 2.25 per cent in 2013.

Although leading central banks will thus probably take further steps down this unconventional path – in part with additional sizeable government bonds purchases – and inflation looks set to remain low and stable, our forecast is slightly higher yields/lower prices for government bonds over the next few years. Yields on 10-year government bonds in the main core countries (the US, Germany and Britain) should rise on the order of one percentage point by the end of 2014.

Arguments supporting this yield increase include:

- Large public sector borrowing requirements.

- Very unattractive government bond yields – in some cases, yields in real terms are negative (the nominal yield is lower than inflation).

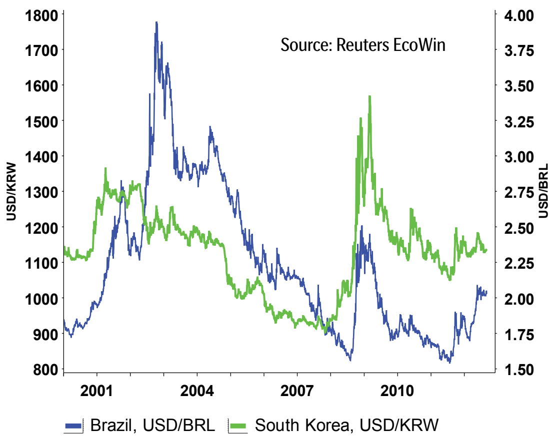
- Potential for decent risk appetite in the financial markets, which usually reduces investor interest in government bonds.

So far this year, investments in corporate bonds – especially the riskier high yield segment – have performed quite well, in some cases posting value growth well above 10 per cent. Meanwhile, investments in Swedish government and mortgage bonds, for instance, have increased in value by only 2-2.5 per cent.

For longer periods, the spreads between value growth in corporate and government bonds are even larger. An investor who decided to buy the US high yield index in early 2009 earned 115 per cent through August 31, 2012 (measured in USD), whereas one who instead chose to invest in the US government bond index (in USD) had to make do with value growth of 22 per cent (in USD). It is also worth noting that an investment in high yield bonds performed almost as well as the S&P 500 stock index during that period, while showing only half the level of volatility (risk).

In many respects, the arguments in favour of high yield bonds still hold: 1) At the microeconomic level, the financial health of companies remains good in terms of profits and balance sheets (in recent years, lower debt levels, increased liquidity, extended maturities on bonds issued). 2) There is still a big yield spread between high yield corporate bonds and government bonds – although not as wide as last winter. 3) The rate of HY bankruptcies was not more than 2.8 per cent (over 12 months) at the end of July, and the credit ratings agency Moody's predicts roughly the same level for summer 2013. Note that the historical average for the bankruptcy rate since 1983 is almost 5 per cent. 4) Prospects of decent risk appetite suggest a financial environment that would favour such corporate bonds.

For these reasons, high yield will also continue to be the most attractive alternative in the fixed income asset class. Nevertheless, it is important for investors to have a comprehensive view of their securities portfolio; should the share of HY in the total portfolio grow too large – which as such could constitute a risk (a few too many eggs in one basket) – there may be reason to reduce this somewhat, despite the attractiveness of high yield bonds in the fixed income portfolio.



EM CURRENCIES SHOULD ATTRACT INVESTORS

During the spring and part of the summer, many emerging market currencies weakened (Brazil's and South Korea's in the chart) as a result of fading risk appetite among global capital investors, but with the shift to a more positive market mood after the first half of the year, they have once again strengthened somewhat. Given decent risk appetite and the search by investors for alternatives to the established reserve currencies (USD, JPY etc.), EM currencies should climb in value against developed market currencies over the next year. There is also room for lower bond yields/higher EM bond prices. EM debt remains an attractive investment alternative.

Better potential for fleet-footed fund managers

- *Share prices are increasingly driven by political developments*
- *Political forces make it difficult for managers who focus on company fundamentals*
- *Global tensions still point toward Relative Value and Macro*

The strong start to the year came to an end in the second quarter. The fading effects of the European Central Bank's Long Term Refinancing Operation (LTRO, three-year loans at 1 per cent interest) reduced risk appetite, while increasing volatility made the market difficult for fund managers to navigate during the second quarter. However, some hedge funds recovered in July and August. The HFRX Global Hedge Fund Index fell 1.9 per cent (in USD) during that period but has risen 0.9 per cent so far this quarter. The market is being driven mainly by investor risk appetite and sentiment, which in turn are driven by unpredictable political decisions. Central bank actions are also driving hedge fund returns to a growing extent, as are hopes for a new round of quantitative easing from the US Federal Reserve (the Fed) or the European Central Bank (ECB)'s potential purchases of government securities from peripheral euro zone countries. Depending on how much these prospects have been priced in, fund managers can benefit to varying degrees from such speculation. Yet regardless of whether fund managers are right or wrong in the positions they take, more fleet-footed managers and strategies will have better opportunities in the coming months.

As before, we divide the hedge fund market into four main strategies:

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

Equity Long/Short

This strategy has had a rough period, with share prices more or less de-coupled from companies' fundamental valuations. Return has instead been connected more to the fund manager's net exposure to the equity market than the choice of equities, so managers with high net exposure to equities have followed the market both up and down. Equity Market Neutral had the hardest time – the strategy has fallen this year by more than 5 per cent (HFRX Equity Market Neutral Index in USD). Risks were brought down in the second quarter, while fund managers have been more restrained about taking on risk again in the current quarter.

We predict that the market will continue to be driven by political developments rather than company fundamentals. The strategies with the best potential in the Equity Long/Short category are fleet-footed ones such as Trading and Variable Net Exposure, where exposures can quickly be adjusted to shifts in market sentiment. Managers who can generate a return both by going long and going short should fare better than those who are more dependent on the general direction of the market. Equity Market Neutral (in USD) will probably be resilient in the slightly more uncertain period we foresee in the immediate future. In a stock market rally, it would not perform particularly well but on the whole should contribute to more positive returns with very low risk.

Relative Value

Interest-bearing strategies had a rough second quarter, with widening credit spreads and high volatility in interest-bearing instruments with longer maturities. Fund managers were and remain generally restrained with their investments at the short end of the yield curve, where yields are low. The HFRX Relative Value Index fell 1.6 per cent (in USD) in May and has trended flat since then. Managers who tend to be short in the credit market generally did well in the second quarter, but the opposite is true for the current quarter, when credit spreads have tightened.

Management styles focused on short-term yields will probably continue to have difficulties for some time going forward. We instead prefer strategies that focus on the medium to long end of the yield curve. Since European Central Bank President Mario Draghi's announcement in late July, which signalled that the ECB may begin purchasing government securities issued by peripheral euro zone countries (Spain and Italy in particular), yield spreads between northern and southern Europe have shrunk. However, we have not seen any concrete action as yet, and the ECB's actions going forward will probably have a major impact on Relative Value strategies. A new round of quantitative easing is also being discussed on the other side of the Atlantic, which also creates opportunity for the strategy – regardless of whether such moves are launched or not. We are therefore positive towards Relative Value and especially fund managers focused on interest-bearing instruments.

Event-Driven and Distressed

Event-Driven is generally dependent on corporate activities such as restructurings, acquisitions and divestitures. However, high volatility and falling share prices in the second quarter led many companies to postpone decisions, and the HFRX Event Driven Index lost 2.7 per cent (in USD) during the period, most of this in May.

Should stock markets continue to soften, the number of corporate transactions may start to rise again. Weak demand and slow growth generally point toward companies trying to grow through acquisitions to a greater extent, which favours Merger Arbitrage. Meanwhile, companies are finding it increasingly difficult to borrow from banks and as a result are focusing on restructuring their balance sheets. Event-Driven fund managers with exceptional expertise in credits and equities thus have the best potential.

Macro and Trading

On paper, Macro and Trading strategies have the best potential given global tensions, but they have also been the greatest disappointments in recent months. Some fund managers have had a negative view on the euro since the turn of the year, and these positions finally paid off in the second quarter. However, profits were essentially generated by bond holdings. As we noted earlier, the market is being driven largely by sentiment, which in turn is driven by decisions in the political arena. It is difficult to factor these decisions into model-driven strategies, and during the year CTA has lost over 3 per cent (in USD), compared to Macro in general, which is down 0.3 per cent.

We still believe that CTA and Systematic Macro belong in a portfolio as holdings that offer an absolute return and diversify risk. CTA models today are generally more negative towards equities and commodities and thus include holdings in government securities and US dollars. These strategies therefore offer good diversification in a pro-cyclical portfolio. However, we foresee the market swinging back and forth, so models with a shorter time frame are preferable.

STRATEGY	INDEX	CHANGE % (USD)			
		Jul-Aug 2012	Q2 2012	2011	2010
Global Hedge	HFRX Global Hedge Fund	0.92	-1.86	-8.87	5.19
Equity Hedge	HFRX Equity Hedge	1.28	-2.65	-19.08	8.92
Relative Value	HFRX Relative Value Arbitrage	0.00	-1.39	-4.00	7.65
Event-Driven	HFRX Event Driven	0.94	-2.67	-4.90	1.98
Macro	HFRX Macro	1.51	-0.52	-4.88	-1.73

Source: SEB

Attractive in low interest rate environment

- *Continued strong demand for quality properties*
- *Growing investor interest in REITs*
- *Real estate bonds a substitute for bank loans*

After a period of quieter sales activity in the global real estate market during the first few months of the year, a significant boost in transaction activity was noted in the second quarter. The sharpest growth on a quarterly basis was in North and South America, while Asia saw the largest upswing on a yearly basis. The property market in Europe also recorded increased activity thanks largely to international investor interest. Nonetheless, activity in many peripheral countries in the region was still weighed down by the lingering sovereign debt crisis.

Primary markets have been the engine

There has been a clear theme in the market for direct real estate investments over the past few years. Investors have sought out less risky and more liquid properties in "primary markets". This investment trend has been the result of persistent uncertainty about the future prospects of the global economy but also a consequence of the low interest rate environment we are currently in.

Two years ago, investors could have put their money into stable quality properties in cities like London, Paris and New York, in many cases generating an annual return of 6-7 per cent, whereas 10-year government securities were selling with a coupon of just above 2 per cent. For understandable reasons, demand for these types of properties grew, with falling returns as a result. Today similar investments generate a return of about 4-5 per cent, which is still viewed as attractive by many investors at a time when 10-year government securities almost everywhere in the Western world are selling at an annual yield of under 2 per cent. If we add the fact that many central banks today are planning, and actively working, to keep both short- and long-term interest rates down for a considerable time to come, our artificially low interest rate environment may well continue to drive up property prices for some time. In light of this, it is understandable that there is still evidently strong demand for properties in primary markets.

But one should bear in mind that a sustained accommodative monetary policy essentially also means a continued weak economy, which in turn has a direct negative impact on the real estate market. Although loose monetary policy spurs rising prices in the short term, a continuing weak economy creates friction for rising prices in the longer term. Combined with the fact that the spread between returns in the primary markets and in riskier secondary markets has widened substantially in recent months, this explains why a growing number of market players have lately begun to take a closer look at, and in some cases to make deals in, riskier markets where properties are thought to be undervalued.

Real estate bonds popular

In the wake of ever more stringent lending conditions and with growing investor demand for a steady return, corporate bonds have become quite a popular investment vehicle in recent years. To fund operations, companies have issued bonds to an increasing extent as a substitute for traditional bank loans. Real estate, which is one of the more capital-intensive sectors, is perhaps also the industry where corporate bond issues have shown the strongest growth. Today there are thus a variety of corporate bonds issued by high-quality companies in the real estate sector that offer a very attractive yield. The funding is advantageous for companies, as is the fact that the loans can be shifted from banks to private individuals and thus eliminate the issue of principal payments.

Strong performance for the REIT market

Another real estate investment that has grown in popularity recently is real estate investment trusts (REITs). This is reflected especially in the growing number of REIT funds on the market; REITs also constitute one of the largest net purchasers in the property market today. Investors seem drawn by the relatively high dividend yields these companies offer (for legal reasons a REIT must pay out a dividend of at least 90 per cent of the company's taxable income) but also by the opportunity these companies provide investors for liquid exposure to the real estate market.

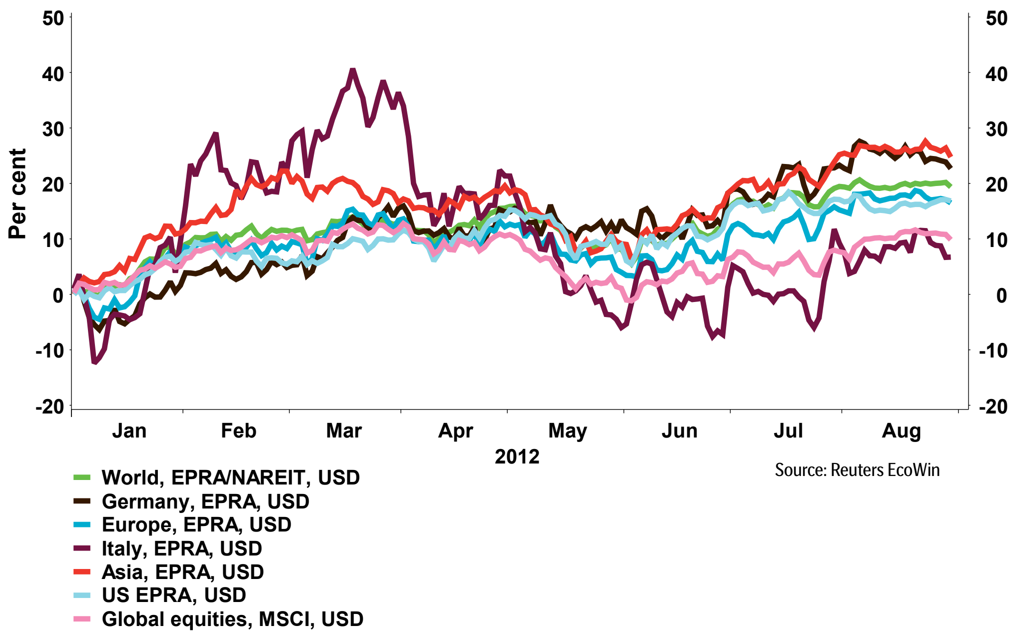
The REIT market has done very well this year. The performance of the global REIT market measured as an index (FTSE

EPRA/NAREIT, World) is up about 20 per cent in USD, while the global equities index (MSCI World All Countries) has shown an increase of about 10 per cent. The US has had by far the best performance over one year, but on a year-on-year basis, Germany and large parts of Asia have seen the strongest performances, with gains of up to 30 per cent. Nevertheless, we note a far more volatile trend for REITs in the peripheral euro zone countries.

More pleasant investment climate in 2012

While investors have taken a relatively cautious approach towards risk for much of the year, many higher-risk assets have turned in a strong performance. Along with the REIT market, global indices for the equity, commodity and high-yield bond markets have done well, giving the appearance that risk appetite in the market has been anything but subdued. One explanation for this ambiguity is that investors have been following a risk on/risk off strategy to an ever decreasing extent, instead basing their purchases increasingly on fundamentals for different asset classes, sectors and companies. One effect of this is that some sectors in the stock market have done well while others have done less well, which is in strong contrast to what we saw in the autumn of 2011, when the co-variation between sectors was significantly higher. Investor behaviour this year thus explains why correlations between assets have fallen, which as a result has created a much more comfortable investment environment in terms of diversification. It has been possible to spread portfolio risks much more effectively across different types of assets.

STRONG PERFORMANCE FOR REIT MARKETS THIS YEAR



The REIT market has posted a far stronger performance than the stock market this year, with a gain of about 20 per cent. The best performers were in Asia and the more stable economies in Europe. However REIT markets in peripheral European countries, illustrated in the chart by Italy (dark red line), had a far shakier ride.

Towards more accurate valuations

- *Continued de-coupling from financial shares*
- *Performance of underlying NAV still strong*
- *Private equity companies taking steps against continued high discounts*

In the last issue of *Investment Outlook*, we argued that the index for listed private equity companies has been increasingly de-coupling from both broad equity indices and financial shares. This is a different case from recent years, when the index for listed private equity (PE) companies was viewed as a high beta variant of broad equity indices and essentially moved in line with financial shares.

It seemed this connection was broken during the first quarter of this year, when the index for financial shares showed a stronger recovery than the index for listed PE companies. We explained recently that this de-coupling, and the weaker trend, was due to three factors:

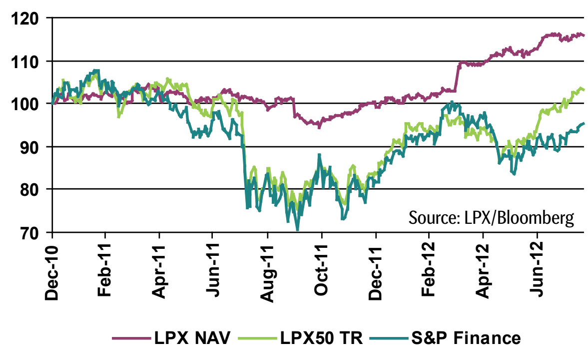
- a weaker and more unstable growth scenario
- an uncertain funding situation
- a flow picture that is hard to assess

The reasoning behind the growing de-coupling from financial shares in particular still seems correct, but recently we have seen a significantly stronger trend for PE companies, both in absolute and relative terms. An explanation of the factors driving listed PE company indices is thus in order.

Strong net asset values

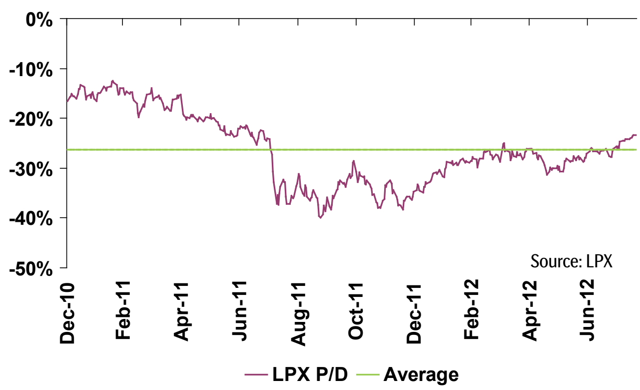
Since autumn 2011, underlying net asset values (NAVs) have stood firm. According to the LPX Index, NAVs have risen 13 per cent since April and 17 per cent since the turn of the year. The sluggish market most likely contributed to PE companies trading in the spring at NAVs like those of last autumn. Combined with concern about debt levels, the result was that listed PE companies did not show the same strength as financial shares. However, rising NAVs and accelerating business activity caused the index for listed PE companies, the LPX 50 Total Return, to gain 17 per cent during the summer (the index is up 23 per cent so far this year).

INDEX REFLECTS RISING NAVS



The underlying NAVs stood their ground in the autumn and spring and have surged since May. This is also reflected in indices for listed PE companies, which have significantly outperformed indices for financial shares.

LOWER DISCOUNTS, A SIGN OF GOOD HEALTH



The discount to NAV index for listed PE companies (LPX50TR) is now less than the discount measured in January 2011 (26 per cent). In a longer-term perspective, the average discount is 30 per cent. Today's level better reflects the underlying trend and should actually be seen as a sign of the good health of companies rather than an indication that the asset class is not as cheap.

The discount to NAV, which indicates the difference between the market value of the companies' underlying assets and the price the companies are valued at on the stock market, fell 12 per cent during the summer, from 31 to 23 per cent, a level that is now below the historical short-term average of 30 per cent and which should be seen as a sign of good health rather than an indication that the asset class is not as cheap. Longer time series show that the historical norm has instead been 10-20 per cent. The spread to the discount in the secondary market, which today is 13 per cent, has also contracted, reflecting the trend of increased business activity. In terms of valuations and activity, unlisted PE companies are now back at early 2011 levels.

Unsustainable discounts to NAV generate activity

The difference between market value and underlying NAV has been considered a universal performance measure and has increased sharply in times of economic distress and weak corporate reports. High discounts have led many PE companies to take steps to improve the investment community's general understanding of the asset class as well as take advantage of the business opportunities created by the discounts. This mainly involves increased dividends for investors to highlight ongoing value creation, share buybacks to strengthen these companies' financial position and acquisitions of other PE companies to strengthen the companies' market position. PE companies have almost always traded at a discount but have not managed to recover since the 2008 financial crisis. If discounts are not adjusted, some kind of consolidation of the PE market cannot be ruled out.

Discounted credit needs

Along with the basic investment climate and general risk appetite, one of the reasons investors have put financial shares on the same footing as PE companies is most likely those companies' need for credit. The 2008 financial crisis and most recently sovereign debt problems have caused banks to be increasingly restrictive in their lending, which has clearly influenced general valuations and the occasional sharp declines caused by waning risk appetite. PE companies have needed to adjust their operations and on the whole have reduced debt-to-asset ratios and extended the maturities on existing loans. Tighter access to credit is reflected in the growing volume of high yield bond issues, up 15 per cent over the past year.

A more restrictive credit market is obviously an important factor, but considering the values and flows attributable to existing portfolio holdings, this has still had a limited impact. A study conducted by F&C Investments (*Private Insight*, Issue 8) shows how PE companies are often among the first to be hit by declining risk appetite, largely because it is commonly believed they are generally highly leveraged. Yet according to the study, this assumption about higher leveraging holds true mainly for the biggest players, since only 24 per cent of the return for mid-size players is attributable to loans. This should also be weighed against the fact that it is largely new transactions that are pushing up debt-to-asset ratios.

Increased activity in a quieter market

During the spring, the exit market remained sluggish, largely because of the volatile market climate and low risk appetite. Anxiety in the market made it difficult for sellers and buyers to agree on a price, so there was limited potential for companies to make good investments.

Risk appetite has picked up since May, with business transactions in the second quarter driven by a large number of large exits. The increased business activity has had a normalising effect on the market, both for buyers and sellers, and is easing some of the earlier heavy pressure to invest, while newly-acquired capital continues to grow. This increased risk appetite may give market players some breathing space, so they can complete transactions they either intended to close earlier in the spring or are accelerating out of fear of returning volatility.

Providing value and better understanding

Given the spread between discounts in the secondary market and for listed PE companies, we believe that, given higher business transactions, this could help provide positive pressure for PE companies to transfer some of this value to shareholders. While these companies contribute to rising NAVs through their active ownership of companies, discounts will remain at fairly high levels. High discounts as such are a risk factor over the long term and should mean that companies will continue working to counter that. At this writing, the political situation in the autumn could very likely result in volatility returning to the financial markets, but given growth prospects for 2013 and 2014 and the ability of PE companies to maintain NAVs in times of weak growth as well, long-term investors still have an opportunity to benefit from value creation and good diversification characteristics by investing in listed PE funds.

Potential in base metals for patient investors

- *Undramatic oil price movements expected*
- *Summer rally in agricultural products, but sharply lower prices in 2013*
- *Many factors point toward rising platinum prices*

This past spring and summer, the commodity market experienced steep price drops and strong upswings. However, since the end of June, the commodity market as a whole has been on the rise. The main driving forces behind this trend are fewer macroeconomic disappointments relative to expectations than earlier in the year and hopes of further stimulus measures in the US, Europe and China. Nonetheless, the generally more positive climate this summer that could be seen in the equity market does not apply to commodities, since there are significant differences between the trends for various commodities.

Sharp movements in oil prices are probably over for the time being. After falling precipitously during the spring, from almost USD 130/barrel (Brent) in early March to below USD 90/barrel on June 21, the price of Brent oil has once again climbed steeply to around USD 115/barrel at this writing, which is equivalent to a rise of about 30 per cent. The strong recovery can be attributed in part to more optimistic macro sentiment, but factors of a more fundamental nature have also propelled the surge. During the spring, the oil market was dominated by a supply glut. One contributing factor was Libya's surprisingly rapid recovery in capacity following the shutdown of production during the country's revolution. Another was a preventive move by Saudi Arabia to increase production in order to offset the loss of oil from Iran (ahead of the embargo against that country, which entered into force on July 1). A further factor is new capacity in Iraq. During the current quarter, this surplus has been absorbed by seasonal high consumption but also countered by production disruptions (maintenance work) in the North Sea as well as the natural fall in production.

In our view, oil prices have now reached the end of this upswing, which began in June (with some upside risk in the near future), and prices during the first half of 2013 should be slightly lower. However, there are still storm clouds on the horizon and persistent factors that can potentially lift oil prices to new heights. The hurricane season could unsettle the market over the next few months. Tensions are growing between Israel and Iran, and there is mounting concern about a military attack on Iran (to get that country to end its development of nuclear weapons), while the turmoil in Syria could spread.

Limited downside for aluminium and nickel

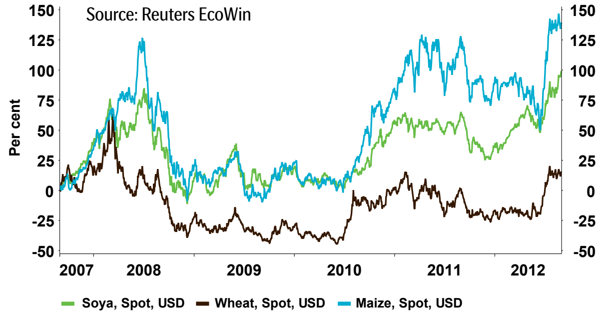
Base metals as a group are currently trading only slightly above the lowest levels recorded in 2010. Since China accounts for about 40 per cent of the global consumption of base metals, weaker growth in that country affects prices. Over the summer, statistics for China in many cases have not met expectations. Combined with continuing uncertainty about the situation in the euro zone, this has held back prices. Some metals, including aluminium and nickel, are currently trading at prices that do not cover production costs. This reduces the risk of falling prices, so these metals offer an attractive potential given their risk. In our view, it should be a good situation for long-term investors to start taking on exposure to the base metal market, especially since some form of stimulus will most likely be forthcoming. Nevertheless, there is still a significant risk that this upswing will not gain momentum until sometime in 2013, since an acceleration in global growth and, above all, stabilisation in the Chinese economy are probably needed. Once this happens, which might be in 2013, there is potential for a rapid rise in prices since they are currently very depressed.

Summer rally over for agricultural products

The price trend for agricultural products this summer stands out, with sharply higher maize (corn) sparking the rally. Inventories were low during the spring, and the market was counting on the coming harvest to improve the situation. The US, the world's largest exporter of maize, was instead hit by a major drought and serious crop damage, which led to substantial downward revisions in production estimates.

Global maize inventories are now at their lowest levels for 50 years. Since the US is the world's largest exporter, inventories there have a major impact on prices, which are now at levels never seen before. The maize rally was not long in coming; since June, prices have surged about 40 per cent and are now exceptionally high. Strong price links between different grains have meant that prices for wheat and soya have also risen sharply.

SUMMER RALLY IN AGRICULTURAL PRODUCTS



The chart shows the summer rally we have had in a number of agricultural products. We can see a deceleration in the price increase and we expect falling prices within a year's time.

Maize prices are currently at such high levels that consumers and importers are cutting back on their use, and there is now far stronger incentive to plant more acreage, which means that there is a limited risk of sustained price rises. In addition, the Chinese maize harvest, which will begin soon, is expected to be very good. It is hard to be certain about the price trend for agricultural products during the rest of 2012, since the turbulence will probably continue, but we expect significantly lower prices in a year's time. Price drops of as much as 30-40 per cent are not unlikely. Weather conditions and future harvest estimates will set the agenda for when prices begin to fall.

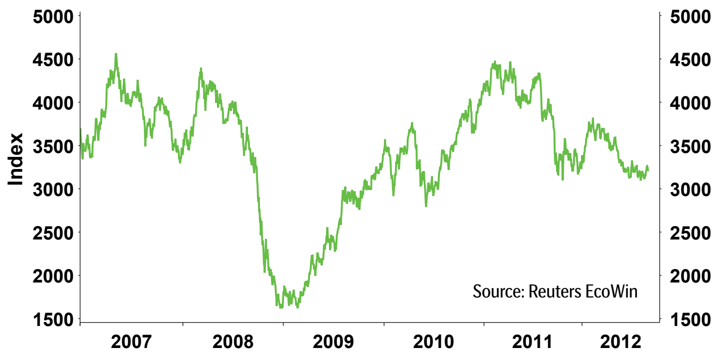
Once growth speeds up, platinum should outpace gold

The price of gold has held up well during the summer despite a strong dollar and the absence of additional liquidity injections. Gold market players seem convinced that the European and US central banks will launch forceful measures with potential to lead investors to gold. The current environment – with low real interest rates, stable investment levels in exchange-traded funds (ETFs) that have physical gold as their underlying asset, and great uncertainty about the financial system – is favourable for gold prices and limits their risk of falling. Over the next few months, we believe there is a good chance gold prices will rise, while in the longer term it is more likely that prices will be on par with today's levels.

The extraction of palladium and platinum has long been held back by under-investment, which has increased the potential for sharp price rises once global growth accelerates. Strikes in South African mines have recently driven up prices further. Furthermore, global vehicle sales are still fairly strong, which has a significant impact on platinum prices, since half the world's consumption of this metal is used in catalytic converters.

Global economy will drive commodity prices

At present, the industrialised OECD countries and emerging markets are both growing at a slower rate than at the beginning of the year, which is not a good signal for commodity markets, where prices are closely linked to the general economic trend. However, on a positive note, there is a lower risk of recession in the US, and the downside risks for OECD economies have decreased. In our assessment, slightly better global growth in 2013 and even stronger growth in 2014 should provide support for commodity prices in the long term, especially given the depressed prices of a number of commodities at present. As we were reminded during the summer, the vagaries of the weather are critical to the price trend for agricultural products.



BASE METALS AT LOW LEVELS

As shown in the chart to the left, base metals are now trading on par with the lows of recent years. A number of metals are now priced far below their production cost, which limits the risk of sharp price declines, while their upside potential is attractive. The underlaying index is World LME Metals index in USD.

FX investors looking elsewhere for safety

- *Major reserve currencies are less attractive ...*
- *... while appetite for smaller currencies in economically strong countries has increased*
- *The Swedish krona is poised to gain a new, higher status*

The problems the major economies in the West are grappling with, such as slow growth and necessary deficit and debt reduction, continue to have a clear impact on foreign exchange (FX) markets. As a result, global asset managers are shifting their sights to alternatives to the major reserve currencies – the euro, US dollar, Japanese yen and British pound (EUR, USD, JPY and GBP) – and taking an interest, among others, in the safe dollar currencies of commodity countries Australia and Canada (AUD and CAD). Since these currencies are less liquid alternatives, they are under constant pressure to appreciate.

The Swedish krona (SEK) has also attracted growing investor interest. This is why the krona, along with other peripheral and fundamentally strong alternatives to traditional reserve currencies, has reached a historically strong level. Still, it is not likely this interest will fade in the near future. Among underlying factors is an improvement in risk appetite since mid-June, which points toward slightly higher appreciation for peripheral currencies in countries with strong current account balances and public finances.

Stronger Norwegian krone this winter

The Norwegian krone (NOK) has not appreciated as fast as the Swedish krona in recent months; nor is it likely to in early autumn, when Norges Bank must significantly boost its foreign currency purchases to settle the Government Pension Fund – Global accounts. But Norwegian interest rate hikes should begin after this period, and the NOK is set to appreciate once again, at least against the EUR. We expect the market to test a level of NOK 7.00 per euro in the first half of 2013. The NOK could also rise somewhat in value against the neighbouring SEK.

In Switzerland, the central bank continues to intervene in order to stabilise the exchange rate between the EUR and Swiss franc (CHF) at the targeted ceiling of 1.20. In Japan, the Bank of Japan is threatening to conduct currency interventions if the yen does not begin to weaken. According to our forecast, both currencies are heavily overvalued, and the JPY in particular could weaken considerably, including against the USD, in the slightly longer term.

The situation for the GBP is completely different. British competitiveness is weak, and there is a strong need to bolster the country's exports. This means that the Bank of England (BoE) will probably undertake further quantitative easing in the form of a raised ceiling for bond purchases, which would quite likely have a negative impact on the pound. Granted, the GBP appreciated a bit against the EUR this summer, but since the UK for various reasons needs a weak currency, intervention from the BoE may well occur if the GBP appreciates more than is desired against the EUR.

A choice between two bad things

Choosing between the EUR and USD means choosing between two tarnished global currencies. It can still not be ruled out that the euro will cease to exist in its present form, with one or more countries exiting the euro project. Meanwhile, extensive measures to support the euro are apparently on the way. If the European Central Bank (ECB) begins major government bond purchases once Spain and Italy have formally applied for a bail-out from the ESM/EFSF rescue funds, the EUR should strengthen temporarily.

But once the initial positive effects on the euro have worn off, there is still the economic and financial reality, dominated by serious challenges and tensions in the euro project as well as a need for the euro zone countries to work more closely on matters such as competitiveness and financial stability. In the absence of such coordination and without a full political union, the euro will remain extremely vulnerable.

A look at the current account balance for the euro zone shows continuing improvement, although this is largely due to weak imports and not increased exports. The currency union as a whole thus has no need for external funding, which is the single most important factor favouring the euro – especially when the US continues to run enormous current account deficits. However, financing the US savings deficit has so far not caused any problems, since the challenges within the euro zone (implementing painful cuts to tackle the sovereign debt crisis and navigating a treacherous political landscape to secure the survival of the euro) are far greater than those in the US.

If the US Federal Reserve launches a third round of quantitative easing (QE3) with further bond purchases during the second half of 2012, that could weaken the USD somewhat. Slightly more depreciation for the currency might emanate from worries about the "fiscal cliff" – automatic budget cuts equivalent to about 4 per cent of GDP which would take effect in 2013 if political leaders cannot agree on an extension of stimulus measures. This would be especially true if the November 6 elections result in Republicans winning a majority in Congress and President Obama is meanwhile re-elected.

In other words, there is a risk that the US dollar will be vulnerable for part of the fourth quarter this year, before a budget solution to limit cuts to about one per cent of GDP – our main scenario – is reached toward the end of the year. Our crystal ball shows a fairly stable exchange rate between the euro and the dollar in the short term. The euro may appreciate somewhat during the fourth quarter, followed by a strengthening of the dollar in 2013-2014 toward 1.15 per euro in December 2014.

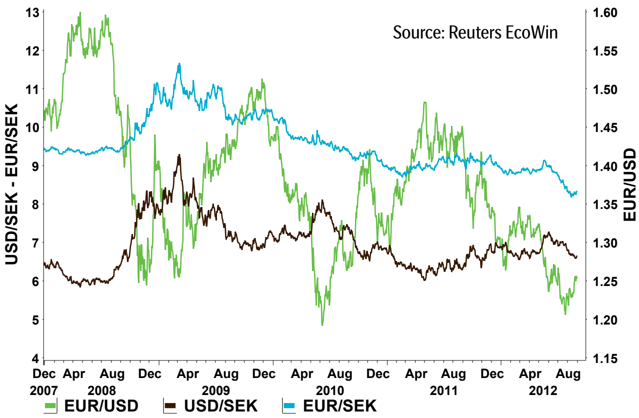
Emerging market (EM) currencies turned in a strong performance this summer as risk appetite in the financial markets picked up. Arguments that also favour these currencies going forward are the search by global asset managers for new safe alternatives to the major established reserve currencies, substantially higher interest rates in emerging markets than in OECD countries and prospects of slightly better EM growth. Among the threats are the risk of setbacks in euro zone policy to resolve the sovereign debt crisis and drastic budget cuts (the "fiscal cliff") looming in the US. Our main forecast is a cautious rise in exchange rates for EM currencies in the next year.

There is an appetite for the Swedish krona

There are several reasons why the krona is being re-priced in foreign exchange markets into a currency that is somewhat less sensitive to economic cycles:

1. From an international perspective, Sweden's government finances and current account balances are very strong.
2. The krona will inevitably be a destination for international capital when safety is ranked higher than return.
3. While many central bankers are actively intervening to limit appreciation pressure on their countries' currencies, the Swedish central bank has been passive. The Riksbank left its key interest rate unchanged in early July while many other central banks took accommodative steps, adding to the strength of the krona.
4. Second quarter growth in Sweden was surprisingly strong, a reflection of good resilience in a tough international economic climate.

The keys to the krona's performance going forward are Swedish macroeconomic data and the Riksbank's actions. The krona is now reasonably priced, and so far the currency's appreciation has been acceptable. In our view, the krona has established a new interval for itself of SEK 8.00-8.40 per euro. Swedish financial market players are historically underweighted in kronor, so there is reason to believe that they will be buying kronor if the currency weakens to around 8.40 against the euro. There are also upside risks for the krona against the euro, and in trade-weighted terms, the krona should appreciate marginally over the next few years. The appetite for Swedish kronor among global capital asset managers should hold, especially since the problems in major reserve currency countries will persist for a long time to come.



STRONGER KRONA AS INVESTORS SEEK ALTERNATIVE RESERVE CURRENCIES

Many peripheral currencies with strong fundamentals, including the Swedish krona, are showing signs of increased demand as an alternative to the big, more established currencies. Neither the EUR nor USD is considered attractive today.