# Investment Outlook

PRIVATE BANKING • INVESTMENT STRATEGY

## Springtime for equities

March 2013

SEB

# Table of contents

Introduction....5
Portfolio strategy....6
Theme: Revenge of the equities.... 11
Theme: Psychological influences on economic decisions.... 14
Theme: What risks are worth taking?.... 16

MARKETS AND ASSET CLASSES
Macro summary.... 18
Nordic equities.... 20
Global equities including the Country Model.... 22
Fixed income.... 26
Hedge funds.... 28
Real estate.... 30
Private equity.... 32
Commodities.... 34
Currencies.... 36

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# Springtime for equities

*The market upturn phase we have seen in late 2012 and early 2013 is based on a positive change of direction in economic data. What we need to ask is whether this stock market upturn is sustainable or not. Is this the beginning of a new long-term phase, or is it a temporary pause in the crisis-affected and volatile period in which we have been for a long time?*

Our assessment is that a new, sustainable phase has started. This issue of *Investment Outlook* examines the potential for such a phase. The coming period probably represents a better equity investment climate than recent years have offered.

One important prerequisite, however, is a level of economic stability that can sustain financial markets through the remaining risks in the world economy. This is because we still have some things to worry about. Political developments in Europe may continue to provide surprises, both in countries that have financial problems such as Spain and Italy and in the overall process of creating a federal Europe.

One interesting question that we discuss in this issue is how our willingness to take risks has changed in recent years. Our willingness to invest and how we view markets are of course largely determined by our past experiences, and the past few years have been tough.

In principle, there is a whole generation of investors who have never experienced the stock market as a source of stable returns. The media occasionally speak of "the death of the equities culture". Such comments usually signal good buying opportunities, but this requires being prepared to take and live with certain risks associated with economic growth. This is another key issue: How do we view the growth trend ahead?

Right now, Europe remains a problem child, the US has fiscal problems and emerging markets are growing, but somewhat more slowly than we are accustomed to. In this context it is important to see the long cycles, which provide guidance about how to view different asset classes in a historical perspective. In our assessment, there are good reasons to be hopeful about the future. There are good opportunities for returns, but as always we must set our expectations at a reasonable level. In our review of the seven asset classes we monitor, you can read more about these opportunities.

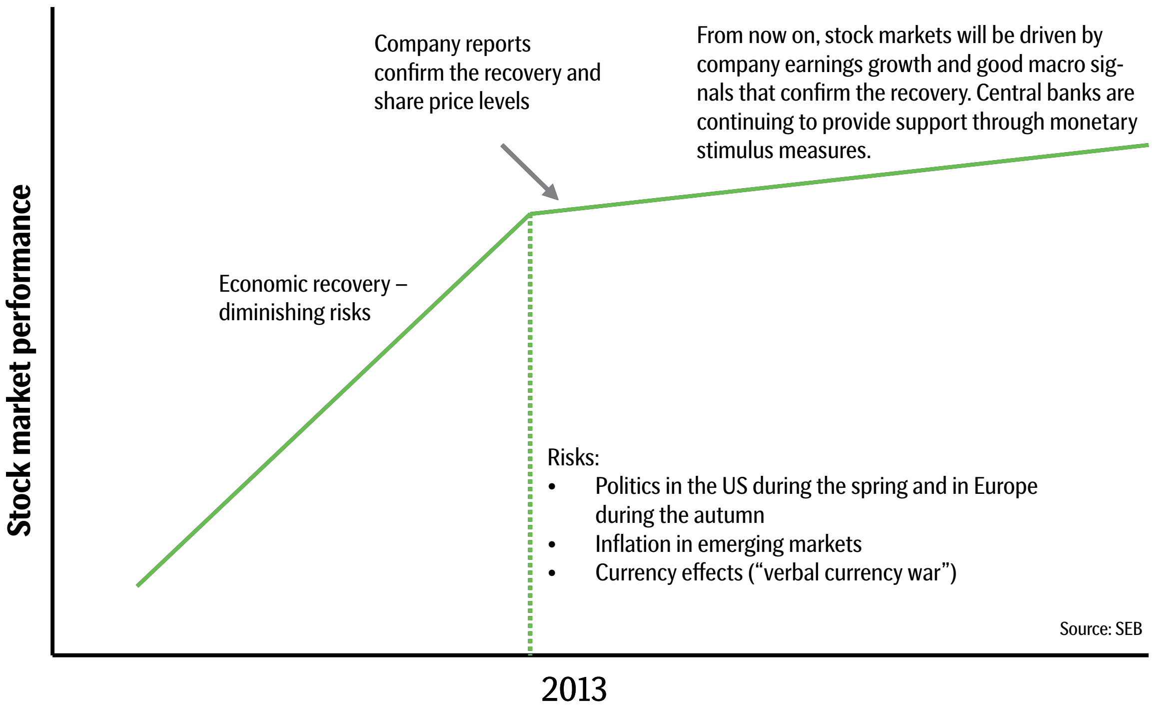
We may very well be on the threshold, or in the beginning, of a new phase. Its structure will be interesting and its potential will fall into place, bit by bit.

**HANS PETERSON**
*Chief Investment Officer Private Banking*
*and Global Head of Investment Strategy*

# 2013 market checklist – three things are needed

- **The economic outlook should provide opportunities for a positive direction**
  The most recent data have provided a picture of a stronger economy, especially in the US and China. Given the size of these countries, their macroeconomic statistics send important signals for the entire world, and good statistics have a stabilising effect on the global economy.
- **Market valuations should be reasonable**
  Valuations have risen in stock markets, due to the sharp price upturn that prevailed early in 2013. Today there is no obvious discount. From now on, market performance will be driven by earnings growth. The latest movement in the spreads between corporate and government bonds indicates reasonable valuations.
- **There should be good liquidity**
  Central banks will continue to support the economy, with the US Federal Reserve's unemployment targets as an example. The European Central Bank (ECB) remains strongly committed to safeguarding the euro. ECB President Mario Draghi has amplified this message through words and actions. Globally, there is a new and more flexible approach to rigid inflation targets.

2013 - ECONOMIC GROWTH WILL DRIVE STOCK MARKETS



## EXPECTED RISK AND RETURN IN THE NEXT 12 MONTHS

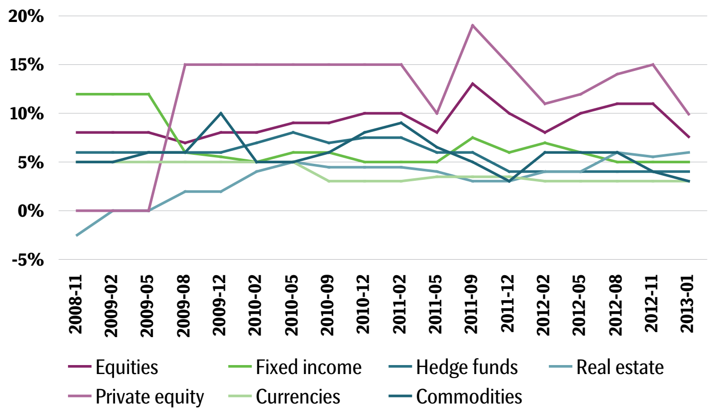
Our risk and return expectations are taken from the SEB House View and are based on our macro scenario (see page 18). These expectations cover the next 12 months. For equities, the forecast refers to the global stock market. For fixed income, the forecast refers to a basket of ½ investment grade and ½ high yield corporate bonds. The real estate forecast refers to the real estate investment trust (REIT) market, while the commodities forecast refers to a basket in which the energy, industrial metal and precious metal categories are equally weighted. As for currencies, the forecast refers to the alpha-generating capacity of a foreign exchange (FX) trading manager.

Since the previous edition of *Investment Outlook* (published on November 27, 2012) we have made two tactical adjustments primarily in the equities asset class, where rapid upturns have caused return expectations to be pulled down to about 7 per cent (from 11 per cent) during the next 12 months at 18 per cent volatility (previously 16 per cent). Since December 1 the global stock market, as measured by the MSCI World index in local currencies, has gained more than 8 per cent. In other words, the recovery has begun. In a very short-term perspective there is obviously a risk of a minor stock market correction, but in the long term the potential for equities remains, especially when compared to alternative sources of returns in the fixed income asset class.

When we make forecasts, we work with 12-month assumptions in order to have a common time horizon for the portfolio simulations we perform. Our position that equities are worth buying is based on our view of them in the perspective of an economic cycle.

| ASSET CLASS | EXPECTATIONS NEXT 12 MONTHS | | REASONING |
|---|---|---|---|
| | RETURN | RISK | |
| **Equities** | 7% | 18% | Equities are reasonably valued, provided that earnings forecasts prove correct. Confirmation is desirable in order to achieve greater stability. Better macro, stable earnings and flows into the stock market will provide good potential. |
| **Fixed income** | 5% | 9% | Spreads between high yield corporate bonds and government bonds remain attractive, while investment grade bonds carry too much price risk at present to be attractive. Less overall potential in this asset class. |
| **Hedge funds** | 4% | 5% | Generally better potential for hedge funds after a challenging 2012. |
| **Real estate** | 6% | 13% | The market has matured, but transparency remains low. Primary markets are the most appealing, but there are also attractive alternatives in secondary markets, although they involve greater risk. |
| **Private equity** | 9% | 24% | Good economic growth and reasonable valuations will provide fine potential in a climate of increasing risk appetite. In case of uncertainty and high volatility, this asset class is more severely affected than equities. |
| **Commodities** | 3% | 18% | Driven by growth in China, which now appears to be stabilising. Yet there are still worries about the economic trend at the global level and about weather conditions. Selectively attractive, with industrial metals as our main investment choice. |
| **Currencies** | 3% | 4% | Strong financial balances, rapid growth, high interest rates, prospects of good risk appetite and OECD monetary policy are reasons for believing that EM currencies will continue to rise in value against OECD currencies. |

Source: SEB




Source: SEB

### CHANGES IN OUR EXPECTED RETURN

*Since the last issue of Investment Outlook (published on November 27, 2012), we have made adjustments mainly in the equities asset class, where return expectations have been pulled down due to rapid share price upturns. The same thing applies to private equity, which has performed strongly in a short period.*

## MAIN STRATEGIES IN OUR PORTFOLIO MANAGEMENT IN 2013

**The stock market is recovering and will see a favourable trend in 2013.**

The global growth trend is favourable and we foresee good economic performance in 2013-2014, which will drive the stock market higher and gradually boost risk appetite. This will mean an increasing inflow of capital into the stock market and out of other asset classes and may be the start of a major recovery lasting 20 years.

**Increasingly growth-oriented, in several dimensions.**

During the period of weakness, stock market investors focused on defensive companies. Now they will increasingly focus on growth companies of various kinds. Continued low interest rates will also benefit growth companies.

**Asian assets in equities, currencies and bonds will remain of interest.**

Good economic growth in China, capital flows to all portions of Asian markets, strong trade figures. Aggressive stimulus programmes in Japan will impact all of Asia.

**Europe – recovery is under way from a low level... valuations are attractive.**

Europe has major growth potential, with a lot of recovery yet to come. The money supply is beginning to rise. Political leaders will probably not impose much more fiscal austerity. Current account balances and eventually productivity will shift in a positive direction.

**Bond yields are gradually on their way up.**

Yields have hit bottom... a strategic challenge for many investors. This will lead to more investments in hedge funds and free investment mandates in fixed income securities and will probably also increase flows into stock markets.

**Corporate bonds will show continued good returns, but limited potential.**

Yield spreads against sovereign bonds remain attractive for corporate bonds with lower credit ratings (high yield), while prices of corporate bonds with top credit quality (investment grade) are currently too risky to be attractive. Less overall potential in this asset class than before.

| ASSET CLASS | WEIGHT* | REASONING |
|---|---|---|
| Equities | 1 2 3 4 **5** 6 7 | Equities are reasonably valued, provided that earnings forecasts prove correct. Confirmation is desirable in order to achieve greater stability. Better macro, stable earnings and flows into the stock market will provide good potential. Focus on Europe and cyclical shares. We are continuing to highlight Asia and emerging markets as the most attractive. Aside from China, we are positive towards less developed Asian countries such as Indonesia, Malaysia and Thailand. Eastern Europe is another attractive investment alternative with low valuations and high growth. |
| Fixed income | 1 2 **3** 4 5 6 7 | Corporate bonds are preferable, with high yield a better value since default assumptions remain low. Spreads have narrowed but remain at reasonable levels. Government bonds are less attractive, since interest rates will move upward rapidly when a more positive economic scenario is discounted. |
| Hedge funds | 1 2 3 **4** 5 6 7 | Market Neutral strategies and those with some element of equity risk are preferable in the prevailing market situation. |
| Real estate | 1 2 **3** 4 5 6 7 | The market has matured, but transparency remains low. We do not currently have this asset class in our portfolios. |
| Private equity | 1 **2** 3 4 5 6 7 | Good economic growth and reasonable valuations will provide good potential in a climate of increasing risk appetite. In case of uncertainty and high volatility, this asset classes is more severely affected than equities. We are choosing not to take this risk in our portfolios right now. |
| Commodities | 1 **2** 3 4 5 6 7 | Selectively attractive, with industrial metals as our main investment choice. |
| Currencies | 1 2 **3** 4 5 6 7 | A lot of attention on the currencies of Asian countries with strong fundamentals. Focus on the yen. |

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

Source: SEB

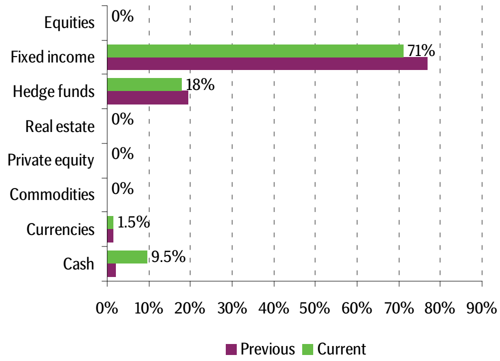
## MODERN INVESTMENT PROGRAMMES

## – ALLOCATION OF CAPITAL ACROSS SEVEN ASSET CLASSES AT THREE RISK LEVELS

### MODERN PROTECTION

Given the risk of rising interest rates ahead, there is a great focus on interest risk neutral investments. About 35 per cent of the portfolio is allocated to Absolute Return managers, who have free mandates and full flexibility to take advantages of changes in the yield curve, thereby maintaining interest rate risk neutral exposure. High yield exposure, which amounts to 12 per cent of the portfolio, consists mainly of short duration high yield bonds and leveraged loans. In the hedge fund sub-portfolio (about 18 percent of Modern Protection) we focus on market neutral strategies for uncorrelated returns and Credit Long/Short in order to offset the portfolio's total credit risk.

The portfolio should thus be able to generate returns even in a climate of rising interest rates. We are comfortable with the current allocation. Looking ahead, however, exposure to Asian currencies (1.5 per cent today) may be increased.

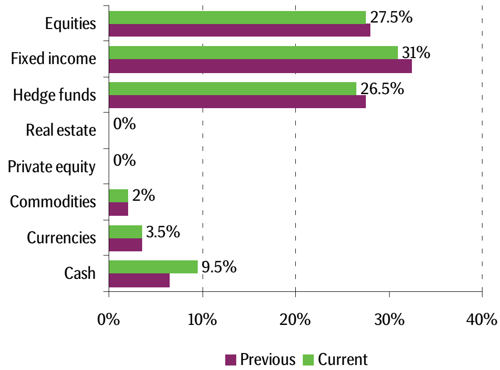



Source: SEB

### MODERN GROWTH

With equity and high yield exposures of 27 per cent each, Modern Growth is positioned for a continued global recovery, but should meanwhile tolerate more negative scenarios relatively well. Hedge funds account for more than 26 per cent, which is aimed at stabilising the portfolio and contributing uncorrelated returns to the total portfolio.

In the equities sub-portfolio, we focus mainly on global equity managers with good potential to provide a better return than stock market indices in a more positive economic scenario. In emerging market equities, we also have a more specific exposure to Asia and China. To cushion the fixed income sub-portfolio against rising interest rates, we have gradually lowered interest rate risk by means of short duration high yield bonds and leveraged loans.

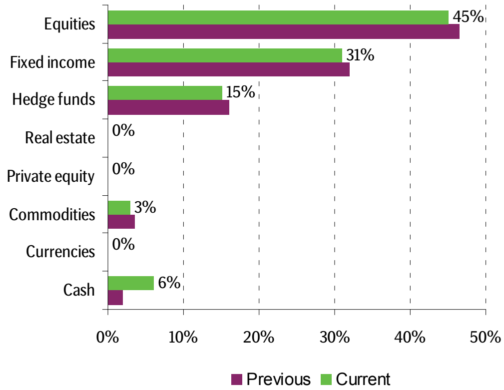



Source: SEB

### MODERN AGGRESSIVE

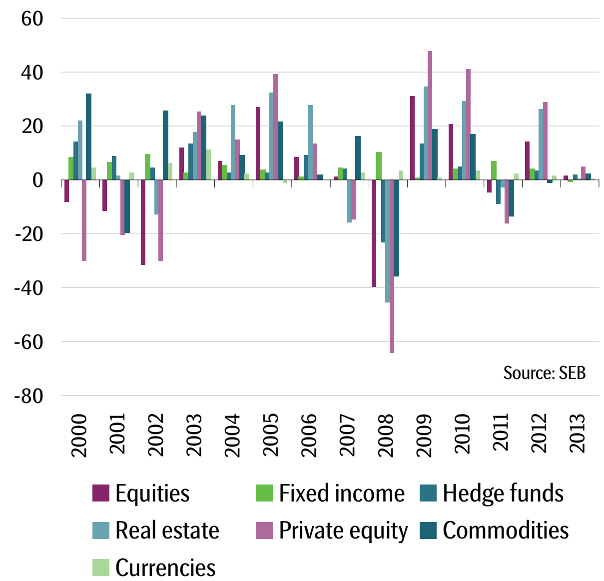
Modern Aggressive includes holdings similar to those of Modern Growth, but the asset class allocation is more aggressive, with an exposure to equities of about 45 per cent, while fixed income instruments account for 31 per cent of the portfolio (22 per cent high yield bonds and 9 per cent emerging market debt). Hedge funds account for about 15 per cent.

In order to achieve its long-term return target, the portfolio has a larger exposure to various risk premiums and thus has a more pro-cyclical nature than Modern Growth, but total risk is currently lower than in the stock market generally.




Source: SEB

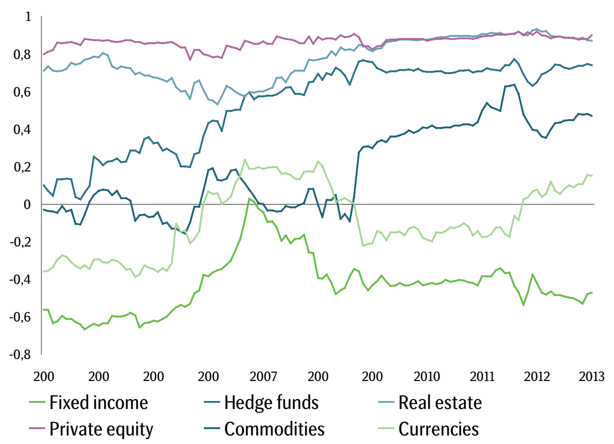
## PERFORMANCE OF DIFFERENT ASSET CLASSES SINCE 2000




Return in 2012 is until December 31. Historical values are based on the following indices:

Equities = MSCI AC World EUR
Fixed income = JP Morgan Global GBI EUR Hedge
Hedge funds = HFRX Global Hedge Fund USD
Real estate = SEB PB Real Estate EUR
Private equity = LPX50 EUR
Commodities = DJ UBS Commodities TR EUR
Currencies = BarclayHedge Currency Trader USD

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




Source: SEB

Historical values are based on the following indices:

Equities = MSCI AC World EUR
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Real estate = SEB PB Real Estate EUR
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Commodities = DJ UBS Commodities TR EUR
Currencies = BarclayHedge Currency Trader USD

## HISTORICAL CORRELATION (OCT. 31, 2002 TO DEC. 31, 2012)

| | Equities | Fixed income | Hedge funds | Real estate | Private equity | Commodities | Currencies |
|---|---|---|---|---|---|---|---|
| **Equities** | 1.00 | | | | | | |
| **Fixed income** | -0.40 | 1.00 | | | | | |
| **Hedge** | 0.68 | -0.32 | 1.00 | | | | |
| **Real estate** | 0.83 | -0.18 | 0.57 | 1.00 | | | |
| **Private equity** | 0.86 | -0.32 | 0.69 | 0.88 | 1.00 | | |
| **Commodities** | 0.36 | -0.21 | 0.67 | 0.32 | 0.43 | 1.00 | |
| **Currencies** | 0.00 | 0.19 | 0.18 | -0.03 | 0.03 | 0.04 | 1.00 |

Source: SEB


# Revenge of the equities

*Ever since the start of the new millennium, markets have been characterised by a weak period for equities and a strong period for bonds. Now that bond yields are approaching zero per cent, perhaps it is again time for a cycle in which equities lead the way forward.*

Ever since the early 20th century, both the bond and the stock market have been characterised by secular cycles, that is, rising or falling price trends that have often extended over more than a decade.

This pattern is clearest for bonds, which since the 1920s have demonstrated regular 30-year cycles, for example falling yields/ rising bond prices from the early 1980s until now. For equities, the time span of such secular trends is more irregular.

Since the Second World War, bond and share prices have sometimes risen concurrently – a secular "bull market" for both asset classes. Sometimes they have fallen concurrently, a secular "bear market" for both, with prices trending downward. Sometimes the bond and stock markets have moved in different directions.

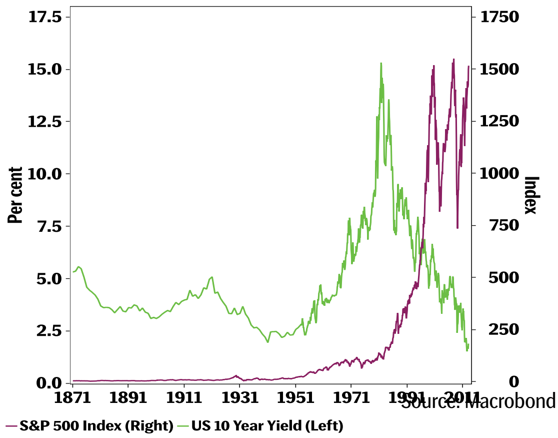
During the 1950s and 1960s equities experienced a secular bull market, while bonds were characterised by rising yields/ falling market prices: a secular bear market. At that time, equities benefited from high economic growth and mounting optimism connected to post-war reconstruction as well as stable exchange rates as part of the so-called Bretton Woods system. This system facilitated international trade. Meanwhile rising inflation and heavy demand for loans to finance capital spending caused a gradual rise in bond yields.

In the 1970s, there was a secular bear market for both bonds and equities. The main reason was the surge in inflation, especially in the wake of the first oil price shock in 1973. Towards the end of the decade, bond yields had been pushed up to record levels, and central banks rapidly began escalating their key interest rates. On the threshold of the 1980s came an extra bonus: the second oil price shock.

Sharply rising interest rates along with decelerating economic growth and greater uncertainty about international trade after the collapse of the Bretton Woods system in 1972 – when many countries let their currencies float – had a clearly negative impact on stock markets. During this bear market period in the 1970s, for example, the S&P 500 index of US equities fell by more than 35 per cent in real terms.

Central banks reacted strongly to higher inflation, hiking their key interest rates and slowing the growth in the money supply. This rather quickly caused inflation and inflation expectations to begin falling in the early 1980s, a trend that persisted during the subsequent decades. Together with a renewed upturn in economic growth, this paved the way for a secular bull market for both bonds and equities, which lasted during much of the 1980s and throughout the 1990s.

## DIVERGENT PATTERNS IN EQUITY AND FIXED INCOME MARKETS




*The past century has shown divergent patterns for equity and fixed income investments, which have become sharper since the 1970s. The turn of the millennium marked the beginning of a historically weak period for equities, but now they have a chance for revenge.*

Optimism among equity investors was also fuelled by the collapse of communism in Europe, symbolised by the fall of the Berlin Wall in November 1989, and by the tech revolution of the 1990s with information technology (IT) breakthroughs in the starring role.

After that, the first decade of the new millennium was dominated by a very severe secular bear market for equities. America's S&P 500 stock market index lost nearly 55 per cent in real terms from early 2000 until the spring of 2009. Meanwhile bond yields continued to fall, resulting in persistent price gains on bond investments. Except for the 1970s, the 2000s decade thus saw the worst total return on shares in more than 100 years, while the total return on bonds set records. Compared to bonds, annual returns in the stock market were thus the most negative of any period since 1900.

The pattern of the US stock market since 2000, for example, has closely tracked the pattern after the 1929 Wall Street crash. But for government bonds, total nominal return since 1999 has been substantially higher (about 130 per cent) than during the corresponding period from 1929 to the mid-1940s (about 50 per cent).

The continued decline in bond yields since the turn of the millennium was due to several factors:

1) The ever-lower inflation rate and signs that there was a risk of deflation (a general decline in prices).

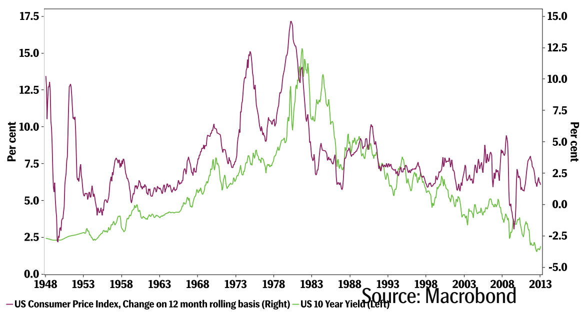
2) After the Asian financial crisis of 1997, a growing interest among investors in the emerging market (EM) sphere in putting surplus savings in the "safe" sovereign bonds of the US and other OECD countries.

3) Changes in regulations that increased the demand for fixed income investments by pension funds and insurance companies.

4) The fact that during the financial and economic crisis of 2007-2009, central banks launched sizeable quantitative easing programmes in the form of bond purchases.

5) The bursting of the dotcom (IT) bubble in 2000-2001, as well as the unprecedented events of 2007-2009, followed by major political dramas during 2010-2012, were a series of devastating events that caused many investors to strategically increase the proportion of "risk-free" bond holdings in their portfolios and reduce their proportion of equities.

**INFLATION AND INTEREST RATES OFTEN HAND IN HAND**




*Ever-higher US inflation caused yields on Treasury notes to rise sharply during the three decades starting in the early 1950s, while lower inflation since then has paved the way for lower yields. Since the turn of the millennium, yields have fallen further mainly due to other factors.*

In March 2009, share prices rebounded. Since then, the MSCI World equities index in local currencies has gained 89 per cent and the S&P 500 index 139 per cent. Meanwhile the decline in bond yields has continued, fuelled by signals from central banks that they will persist in their ambition to help sustain economies and financial markets with zero interest rates and bond purchases.

Among key questions that asset managers should now be asking is whether March 2009 marked the beginning of a new secular bull market for equities and whether – as a consequence – equities as an investment will be able to take revenge on bonds. The latter asset class was a far better investment during the first decade or so of the new millennium.

One central concept that can help our analysis and enable us to answer these questions is equity risk premium (ERP).
**ERP = company earnings/share price (earnings yield) minus 10-year government bond yield.**

At present, this risk premium is very high – in the U.S. around +5 per cent based on the S&P 500 – as a result of low share prices relative to company earnings (synonymous with high earnings yields and low price/earnings ratios), along with historically low government bond yields. During the post-war period, only in the 1970s were risk premiums on equities at such high levels (even though bond yields at that time were substantially higher than today).

Aside from reflecting extremely low bond yields, today's high risk premium on equities reflects investors' low expectations about economic growth coupled with their great uncertainty about the economic outlook. Taken together, this has resulted in lower expectations about potential stock market returns. In other words, equity investors are currently reluctant to pay very much for each unit of company earnings. The opposite was true at times during the 1980s and 1990s, when the risk premium in the US occasionally dropped to as low as -3.5 per cent. During the post-war period, the average risk premium in the US has been slightly positive.

Looking ahead, our main scenario is that the risk premium will fall from its historically high level – the premium has rarely stayed so high during any extended period. But whether this occurs mainly because earnings yield falls (share prices rise in relation to company earnings) or mainly because bond yields rise is of course extremely important to investors.

### First, looking at government bonds

Here the message of history since the 1920s is clear; after thirty years of falling bond yields, it is now time for the yield cycle to turn upward. There are many indications, summed up in historically high bond valuations, that a long-term upturn in these yields is imminent and that a secular bear market for bonds is thus about to begin.

Arguments in favour of this are the prospect of gradually stronger economic performance for at least a few years, decreasing financial risks that in themselves make "safe" government bonds less attractive among investors and expectations of somewhat high inflation ahead. Generally greater risk appetite, as well as greater optimism about financial asset markets, will also cause investors to sell bonds and buy equities.

During the next couple of years, however, any upturn in bond yields is likely to be rather modest. First, by all indications many central banks will persist with their historically accommodative monetary policies for quite a while. Second, the risks of clearly higher inflation are fairly small as long as capacity utilisation is low (which applies mainly to the OECD countries). Third, "fleet-footed" investors such as US households have a rather small percentage of fixed income investments in their portfolios (about 25 per cent). Meanwhile the Fed and other public sector market participants – which would not suddenly sell large quantities of bonds – now hold a full 50 per cent of all U.S. Treasury securities in circulation.

The main risk to our scenario of modestly rising bond yields would be surprisingly weak economic growth coupled with actual deflation or expectations of widespread deflation, which would cause bond yields to continue falling.

### Turning now to equities

Moderate upturns in bond yields in keeping with our scenario could probably be accompanied by rising share prices, if both these movements reflect improved economic performance with only slightly higher inflation expectations.

Analysts and investors naturally focus on fundamental factors behind stock market returns, such as the outlook for economic growth and corporate earnings, as well as changes in corporate profit margins. At present, there is a widespread perception that these factors will not help equities very much in the near future. This is due to expectations of continued slow economic growth in the wake of fiscal austerity and persistent deleveraging by households, banks and governments. This assessment is clearly reflected in the now historically high risk premium on equities.

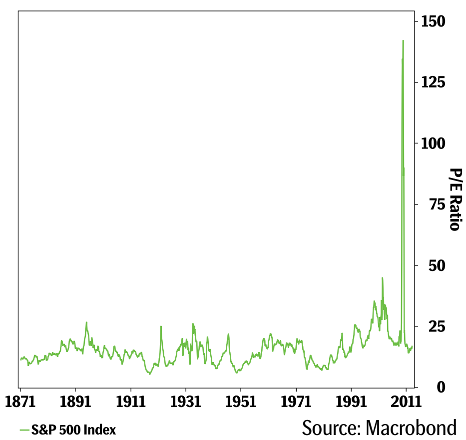
Yet it is important that investors not only focus on the "old" OECD industrialised countries, but also include the significantly faster-growing EM sphere in their world view. Largely due to rapid and accelerating growth in the EM sphere, according to SEB's forecast world GDP growth will surpass its trend rate (just below 4 per cent) during 2014. In addition, overall fiscal tightening in the OECD countries will be a bit less severe in the near future, and monetary policy in several countries (Japan, the US and the UK) is shifting more towards helping sustain economic growth. Looking at American households, which remain important in a global economic perspective, it is also worth noting that their debts as a percentage of income have fallen significantly over the past two years and that the asset side of their balance sheets is gaining strength, due to rising prices for both homes and financial assets.

Valuations are another extremely important factor for the stock market outlook. This is because history shows that periods characterised by significant declines in share valuations – rising earnings yields and falling P/E ratios – such as during the past decade or so, have usually been followed by periods of strong share price performance. Looking back, another observation is that secular bear markets often turned into secular bull markets when valuations were low, unemployment rising and real interest rates (nominal interest minus inflation) negative. This was true in the spring of 2009…

Looking at the MSCI World equities index, today's valuations are below historical averages. The consensus forecast for global corporate earnings is growth of nearly 10 per cent over the next 12 months. The ex-ante P/E ratio (12 months ahead) would thus end up below 13, compared to an average of 15 for the past 25 years. Share valuations that are in no way challenging are a further argument why a secular bull market may have begun in early 2009, during which earnings yields will thus fall and P/E ratios will rise.

Short-term factors that may challenge such a positive equities scenario include escalating disunity on US fiscal policy, a bursting bond bubble with sharp yield upturns similar to what occurred in 1994, newly occurring economic and financial problems in the euro zone as well as disappointments and emerging risks in the Chinese economy.

**Conclusion:** Given the prevailing very high risk premium on equities, there is a higher than normal probability that equities will provide historically good returns from their current price levels. Given the prevailing very low risk premium on bonds, there is also a higher than normal probability that bonds will provide historically poor returns from their current price levels. Case closed.



Source: Macrobond

### LOW VALUATIONS PRECEDE GOOD STOCK MARKET PERIODS

*Since the industrialisation wave of the 1870s valuations (P/E ratios) of S&P 500 shares, for example, have rarely been below 5 or above 25. The period around the turn of the millennium was therefore rather unique, with P/E ratios substantially above 25 for a rather long time. Equities were unreasonably expensive at that time, and valuations have fallen significantly since then due to major stock market slides. Otherwise, periods of low share valuations are usually followed by good stock market periods. (The extremely high P/E ratio in 2009 was due to the collapse in corporate earnings during that year's financial crisis.)*

# Psychological influences on economic decisions

*In economic theories, everything is rational. In mathematical terms, it is simple – 1 is always 1. But when we make decisions that involve different potential actions, we become uncertain. After all, we have no grasp of the future. Different outcomes are possible and we are unsure. That leaves room for both external and internal psychological influences.*

We have been living in a financial crisis for more than a decade. Perhaps it has lasted even longer. In the past ten years, equities have had historically low returns at normal/high risk. Meanwhile, low-risk investments (forests, real estate, fixed income instruments etc.) have provided high returns. So in a period like this, most asset classes have generated far from average returns. The risk/return ratio has thus not always been consistent with long-term equilibrium.

If we now try to bring together psychology with economic facts, we may be able to pursue a different kind of discussion about what we perceive as risk today. How we view risk is based partly on common sense, partly on mental heuristics ("rules of thumb"), but also partly on our own biases and especially the biases of others. One key factor in decision making is the herd. Where everyone else is headed often has a reinforcing effect. The herd, probably quite rightly, has long fled what it perceives as high risk.

Some of us (though far too few) remember the late 1990s, when the stock market had enjoyed annual returns of 20 per cent since the 1980s. P/E ratios were high, but most investors considered these valuations acceptable. The outlook for the turn of the millennium was very bright. Today, after 20 years of low returns, with P/E ratios at average levels, many people say valuations are high. The future looks bleak in our part of the world (Europe), which has a major impact on perceptions of risk and return.

Throughout human evolution, our brains have been coded in various ways to ensure survival, in part by giving our memory functions a certain structure. For instance, it is easier for us to remember what happened most recently and what is visible to us. Our experiences and knowledge are stored in different parts of our memory but are not retrieved equally automatically and quickly.

The brain creates rules of thumbs (shortcuts) based on our knowledge and experiences but also on how we perceive reality. Since reality can be perceived in different ways by different people, we will all have a subjective view of reality. A company share can be considered expensive depending not just on the price that day but on our own expectations of its future price, comparative prices looking back in time and prices of other shares. That in turn leads to systematic errors of judgement (preconceptions), which is known as bias. Rules of thumb usually result in pretty good decisions, but by over- and underemphasising the relevance of different information, our conclusions are more or less biased.

Below we will go through some of the most common rules of thumb and the preconceptions connected to them. The aim of this theoretical argument is to determine how we should assess future returns and their associated risks in the current market. Do we base our assessment of probabilities on scientific grounds, or do psychological factors have a greater impact than we think?

One rule of thumb is the "availability heuristic", which means that decisions are made based on how easy it is to find information about the matter at hand. If I am thinking about increasing the bond holdings in my portfolio, my desire to do so will increase if others around me (people, the media) are saying how good it is to own bonds.

Another rule of thumb is the "representativeness heuristic", with its accompanying "representativeness bias". Can an object always be assigned to a given category? People have their ideas about the typical growth company, the typical economist, the typical start of a recession. If we meanwhile ignore other factors, the result is bias. Representativeness bias is connected to how people always want to see meaningful patterns in their environment that correspond to their conceptual categories. People see patterns in random outcomes.

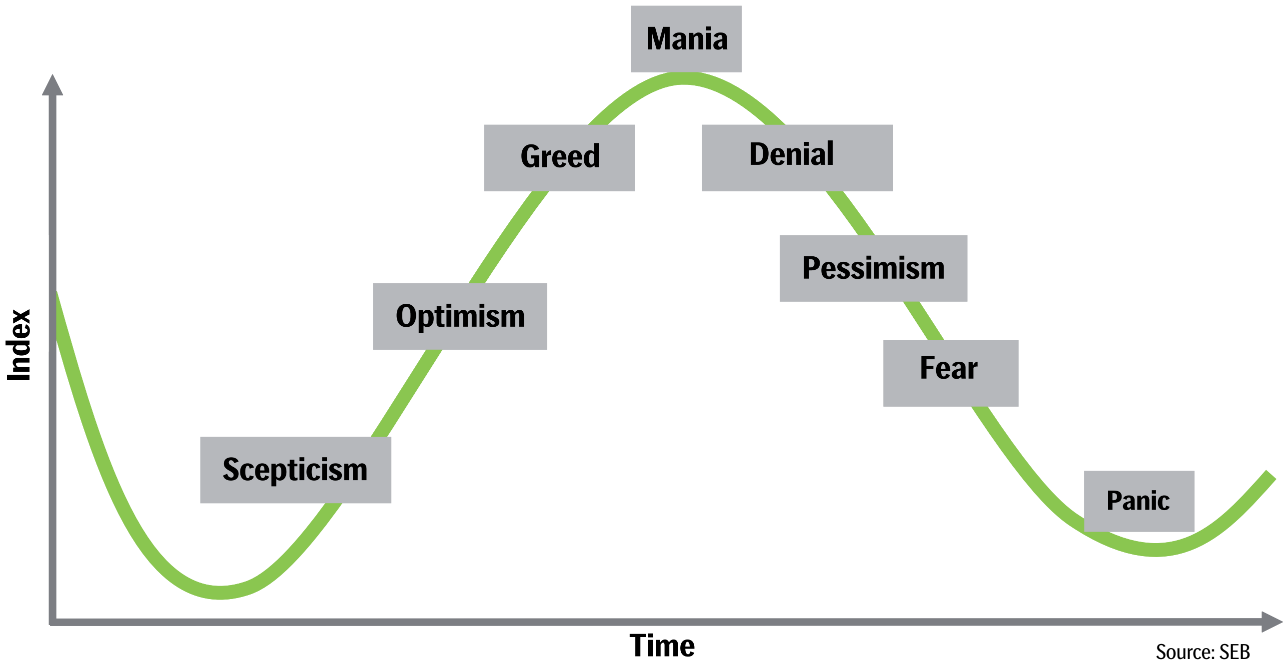
A third rule of thumb is the "anchoring heuristic", which in turn is connected to "anchoring bias". Anchoring means we have an initial reference point, an anchor, which is then adjusted relative to other available information. Science shows that adjustments usually end up being close to that reference point, so there is bias in the decision. Take forecasts, for instance. They always seem to be close to the figures later reported. The anchoring bias means that people are not prepared for significant changes in their reference point.

Preconceptions also arise when people overvalue certain evidence and undervalue other evidence, which results in unwarranted certainty in decision-making. This "confirmation bias", as it is known, can lead to efficient, consistent actions. It eliminates doubt and provides a reason for sticking to one's views.

Along with rules of thumb and their preconceptions, there are other psychological factors that influence decision making amid the uncertainty that all questions about the future generate. We especially undervalue the importance of the herd.

If risk assets such as equities have had high risk and abnormally low returns, according to the theoretical notions above we will probably not see or believe in the shift to a more normal period. On the other hand, the bond market has generated high returns at low risk in recent years and, according to this argument, seems very safe. But what happens if the global economy starts to improve and interest rates generally rise? Especially if the situation improves in parts of the world that are not nearby, but where our listed companies have significant operations? We will have a hard time perceiving changes ahead and acting rationally.

THE STAGES OF HERD BEHAVIOUR




Source: SEB

*Mental shortcuts (rules of thumb or heuristics) lead to systematic errors of judgement. When combined with herd behaviour, it is difficult to perceive changes ahead and act rationally.*


# What risks are worth taking?

*Capital markets have entered a new phase after the recovery that began eight months ago. With the upturn confirmed, we now ask ourselves two questions. Where shall we take risks today? And what risks are worth taking?*

Seldom has one man come to symbolise a period as much as European Central Bank President Mario Draghi has done, through his verbal promise to "do whatever it takes" to preserve the euro – something that demonstrates the need for confidence in crisis situations. At least for the moment, this confidence has given back investors their risk appetite. Stock market rallies have quickly ensued.

We are in a growth phase, and this is generally good for growth-driven investments. We have reached a period when the stock market should be the primary source of returns. Meanwhile, as always, there are reasons to be thoughtful when it comes to expectations and how we take risks via stock markets. Force of habit is powerful in the investment world (see also the theme article, "Psychological influences on economic decisions"). There is reason to believe that some of the patterns in recent years will not be repeated.

**Commodity markets** are one example, where we may not quite see the same developments we have become accustomed to. These markets are showing a slightly more cautious pattern than before. Many investors are moving out of gold and other precious metals as their risk appetite increases. This may be regarded as a good barometer of the recovery we are seeing in the world. Meanwhile there are continuing opportunities, for example in certain precious metals that are more dependent on industrial uses, and especially in purely industrial metals. But we may not see the same dynamism in commodities and commodity-related investments in the future. To some extent, this is connected to China's shift from production- to consumption-driven demand. The currency issue is also part of the picture, since the weak US dollar has absorbed some of the upturn in commodities, but we will probably see a reversal of the downward dollar trend.

Economic growth is currently the driving force for financial markets in most regions. Europe remains a problem child, but its rate of change should be positive from this point onward. Political leaders have made considerable progress in implementing fiscal austerity, current accounts are stronger and demand should not slow decisively, since the world economy is generally moving in a positive direction. Another important parameter is investor optimism and confidence in political leaders on various issues. The US situation has not been resolved, major steps remain to be taken towards European federalism and the situation in foreign exchange (FX) markets may become a political issue in the future. All of this is likely to continue limiting investments and activity. On the other hand, there is attractive potential if the existing issues are resolved in a constructive way.

Central banks continue to reiterate their commitment to supporting economic growth. The Federal Reserve's unemployment target is a very clear example of this. The European Central Bank's actions have also been very clear, and perhaps the most skilful right now, since the ECB has earned such great confidence that the bank is operating via press releases rather than via liquidity.

**Equities** are the asset class that should benefit the most from today's market situation. Today we can note that share valuations have climbed a bit, and what was quite cheap six months ago is more normalised today. Comparing stock market valuations with bonds, however, equities still seem cheap. If we extend our perspective to 2014 and believe there will be continued recovery, the potential for equities is good.

So where do we take risks? The upturn we saw late in 2012 and early in 2013 can be viewed as the first phase of the recovery, the phase that usually favours the most cyclical companies. At present we are in a more stable phase, where market players are seeking good earnings growth and reasonable valuations. Combined with low interest rates, this makes growth companies with limited dependence on economic cycles attractive.

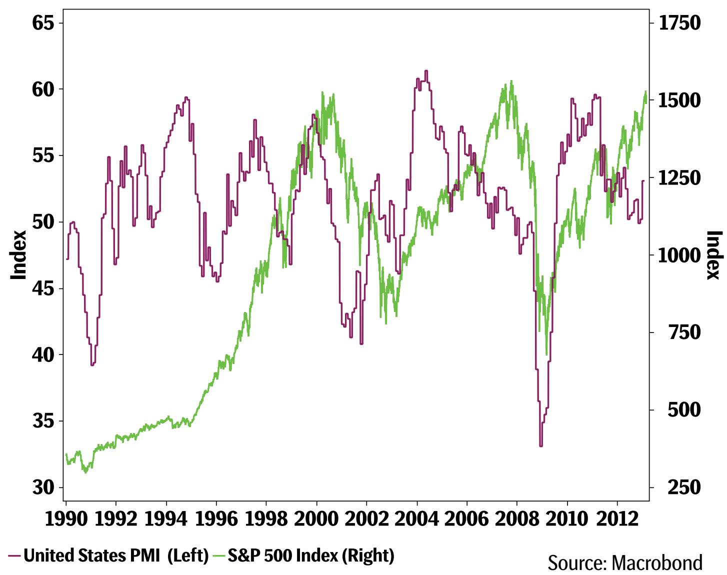
Countries whose stock markets demonstrate good earnings growth combined with good valuations will be in sharper focus. Earnings growth will be driven by increased global trade and domestic growth. Among attractive places where this will happen is China, but also Sweden.

**The bond market** has reached a turning point. We have a continued positive view of corporate bonds, but we have to stress that the potential today is significantly lower than before. We are close to a low point in the yield gap between corporate and government bonds, and we foresee returns more in line with actual running yield. But it is important to emphasise that the ongoing stabilisation of the economy should keep credit risks down somewhat, which in itself enables corporate bonds of different credit quality to remain attractive.

One asset class that has perked up in recent months is **hedge funds**. Put simply, we can divide hedge fund managers into two categories: those who need harmonic, stable markets and those who thrive in times of crisis with large market movements. What we have seen in recent months is that markets in general have matured. We have not seen the same highly volatile patterns as during crisis periods, resulting in more rational pricing. This in turn enables highly analytical fund managers to earn a better return on their ideas. We view this positively, since we need alternative asset classes as a tool to control risks in our portfolios.

During periods when stock market valuations mature along with the economic cycle – that is, when growth stabilises and improves and stock markets have periods of flatness – hedge funds are attractive.

We foresee a number of good sources of returns today. The potential is there. We have probably passed the first quick surge after the crisis and before the stabilisation phase, but one very interesting sign today is increased merger and acquisition (M&A) activity, which indicates optimism. Professional market players are beginning to take clearer risks. The next step should be an increase in capital spending and finally higher employment. Then the wheels will have started spinning, leading to better market performance.




Source: Macrobond

## STRONGER SIGNALS FROM MANUFACTURERS BENEFIT EQUITIES

*Historically, there is a high correlation between the purchasing managers' index in the US manufacturing sector and American stock market performance. Manufacturing activity is again increasing (the index exceeds 50), which may be an indication that a new phase is beginning in the stock market.*

# Good forces are about to take the upper hand

- *The world economy still faces many dangers...*
- *... but the good forces are becoming more numerous, paving the way for higher growth*
- *Economic policy missteps are the main risk; unexpectedly rapid recovery in the US and China is the main opportunity*

Despite many challenges and risks in the political world and the continued deleveraging needs of households, governments and banks, the global economic growth rate will increase in 2013 and 2014. Central banks will set new monetary stimulus records, reducing financial stress and helping sustain asset prices. Meanwhile monetary policy in a number of major countries is focusing on better sustaining growth, increasing the likelihood of historically low key interest rates for an extended period. In addition, the recovery in the US and China is now on firmer ground, and Japan's big economic policy initiative to stimulate growth and generate inflation is likely to help lift the global economy, at least in the short term. In Europe, imbalances are indeed large but they are diminishing. The competitiveness of Europe's crisis-hit countries is improving via lower wages and higher productivity, while their borrowing costs are falling. The likelihood of a euro zone collapse has thus decreased.

Growing uncertainty about world economic policy could nevertheless lead to a worse economic scenario than expected, while surprisingly strong growth in the US and China would mean a faster global upswing than in our base scenario (60 per cent). We estimate that these downside and upside risks have an equally large probability (20 per cent)

### US economy in the hands of political leaders

In the United States, household debt has been reduced to levels that are sustainable in the long term. Together with the continued rise in home prices, this will benefit private consumption. Housing construction is rising, and a business investment rebound is also in the cards. In the short term, however, there will be no clear growth surge because of fiscal tightening, which we estimate at 1.5 per cent of GDP this year. New fiscal policy trouble spots and political stalemates are the biggest risks to our relatively positive US scenario. We expect GDP to grow by a bit more than 2 per cent this year and by 2.5-3 per cent in 2014. Due to low inflation pressure and unemployment that is expected to remain above the Federal Reserve's new monetary policy benchmark of 6.5 per cent for some time, the Fed will hold off until the spring of 2015 before hiking its key interest rate. Its current bond purchases (USD 85 billion per month) are likely to have ended earlier, before the summer of 2014.

### Euro zone slowly emerging from gloom

Economic activity in the euro zone seems to have bottomed out in late 2012. Various indicators have improved in recent months, among them purchasing managers' indices for services and manufacturing. This winter there have been a number of bright spots in the German economy, while France has delivered disappointments. Meanwhile there is great political uncertainty, the banking system is not finished healing and fiscal consolidation is still under way. On the other hand, tough political decisions have been made and fiscal consolidation in various crisis-hit countries has made some progress. We expect euro zone GDP to fall by nearly 0.5 per cent this year and to grow by almost 1 per cent in 2014. Since the euro zone fiscal crisis has become less acute and the borrowing costs of crisis-hit countries have fallen significantly, our assessment is that the European Central Bank will let its refi rate remain at 0.75 per cent until 2015 and will launch no new monetary policy initiatives.

### British inflation stubbornly high

In the United Kingdom, fiscal austerity policies remain in place. Together with weak exports, this is holding back growth. After last year's stagnation, we still predict that British GDP can grow by about 1.5 per cent both in 2013 and 2014. Recently, inflation has been surprisingly high, and in 2013 it will exceed the Bank of England's 2 per cent target for the ninth straight year. The BoE will thus abstain from expanded bond purchases and leave its key interest rate unchanged at 0.5 per cent until 2015. After Prime Minister David Cameron's recent policy speech, it is clear that the UK will hold a referendum on EU membership in 2017 if the Conservatives are then still in power, creating great uncertainty among many British companies for the time being.

### Nordics must rely on domestic markets

A relatively sluggish global recovery means that the Nordic countries must rely on stronger domestic demand – consumption and capital spending – in 2013-2014. Norway will be sustained by both the domestic economy and the oil sector. Swedish growth will gradually accelerate thanks to stronger household purchasing power. Danish households are squeezed by high debt and a weak real estate market, while Finland will get less help than desired from the global economy. Overall Nordic GDP will grow by less than 1.5 per cent this year and more than 2 per cent in 2014.

### Flying start for Japan's new economic policy

The new Japanese government made a flying start in 2013, with a large-scale fiscal stimulus programme as well as a higher inflation target and plans for new asset purchases by the Bank of Japan. Expanded purchases, as well as purchases of riskier assets, may also begin after the current BoJ leadership is replaced in mid-March. As a consequence of stimulus measures, the yen has weakened sharply, paving the way for higher exports and imported inflation. Overall, we believe that GDP will grow by about 1.5 per cent both in 2013 and 2014, but the government's dramatic economic policy initiatives represent a gamble with public sector finances. Sovereign debt will exceed 250 per cent of GDP in 2014, jeopardising Japan's credit rating.

### Domestic demand in Asian emerging economies

Although Asian emerging market economies face continued weak demand from the US and Europe, this is offset by good domestic demand – largely driven by strong private consumption. Meanwhile intra-Asian trade is growing in importance. Inflation is still subdued in the region, and monetary policy will thus remain accommodative during much of 2013.

In China, political uncertainty increased during 2012 but is now diminishing. This will help sustain both capital spending and consumption. The country also has economic policy manoeuvring room and can stimulate the economy as needed. We predict GDP growth of more than 8 per cent this year and 7.5-8 per cent in 2014. The risk picture includes China's dispute with Japan over some small islands, overblown home prices and higher inflation. Late in 2013, we expect the central bank to hike its key interest rate from 6 to 6.25 per cent.

India's economic growth bottomed out last autumn. Since then, purchasing managers' indices in the business sector have climbed. Because of its large deficit, the government cannot use fiscal policy to stimulate growth, but inflation faded somewhat this winter, opening the way for the central bank to lower its key interest rate to 7.75 per cent in January. We predict that by December 2013 the key rate will have been cut in stages to 7 per cent. We estimate that India's GDP will grow by more than 5.5 per cent this year and 6 per cent in 2014.

### Mixed forecast for Latin America

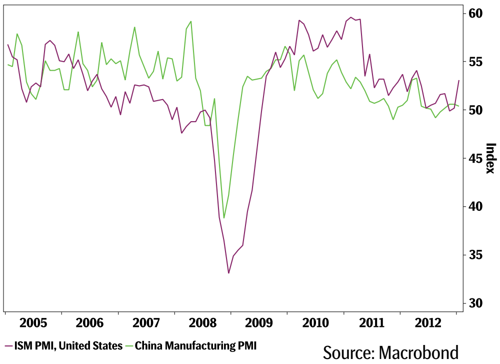
Both GDP growth and inflation slowed down in Latin America last year, while deficits in the overall current account balance and public finances grew. The outlook for the next couple of years appears better in some respects. GDP growth will increase from 3 per cent in 2012 to about 4 per cent annually in 2013 and 2014, while negative public budget figures will be smaller than last year. However, current account deficits and inflation rates will increase in 2013. Among individual economies, Chile and Mexico stand out in a positive light, and Argentina in a negative light (the International Monetary Fund is scrutinising the country due to untrustworthy macroeconomic statistics)

### Eastern Europe stabilising, no growth surge yet

A consistent feature across Eastern and Central Europe has been depressed industrial output, mainly due to weaker demand in Western Europe. Meanwhile there are signs of stabilisation in economic indicators during the past few months. There is levelling out or slight upturns in Poland, the Czech Republic, Slovakia and Hungary. In 2013-2014 we foresee more rapid growth in Russia and Poland than in many other countries in the region. Some central and especially southern parts of the region are more depressed. The Czech Republic and Hungary will emerge very slowly from recession, and both Slovenia and Croatia risk GDP declines again. Inflation is trending lower in most of Eastern Europe, with Russia and Ukraine as exceptions. The gradual recovery in the Baltic countries will continue, though it will be shaky. Weak exports and low capital spending appetite, mainly in Lithuania and Latvia, are hampering expansion early in 2013, while private consumption is chugging along at a healthy pace. We foresee Baltic GDP growth of about 3.5 per cent this year and 4 per cent in 2014. Latvia is expected to meet all the criteria in its ECB/EU evaluation this spring by wide margins and can thus convert to the euro on January 1, 2014.

### The world economy is poised for acceleration

During 2010-2012, world GDP (adjusted for purchasing power parities) gradually slowed. Last year's figure was below 3.5 per cent. But around the turn of the year, the global economy began a recovery. In our assessment, this will enable world GDP to grow by more than 3.5 per cent this year and a bit more than 4 per cent in 2014. With growth figures of 5.5-6 per cent annually, the emerging market (EM) sphere will remain well ahead of the OECD, where we foresee yearly GDP growth of 1.5-2 per cent.




Source: Macrobond

### WHEELS OF INDUSTRY ROLLING AGAIN

*Especially in the US, but also in China, purchasing managers in manufacturing are now signalling a return to expanding activity. Many other macroeconomic statistics also show stronger underlying growth in these countries, which we believe may lead to upside surprises in the world economy during 2013-2014.*

# Growth is valuable

- **Equities are again attracting investors**

  After a long period of being rejected in favour of fixed income investments, equities have again begun to attract investors. The latest statistics show inflows into equity funds both in Sweden and internationally. This may well be a trend reversal.

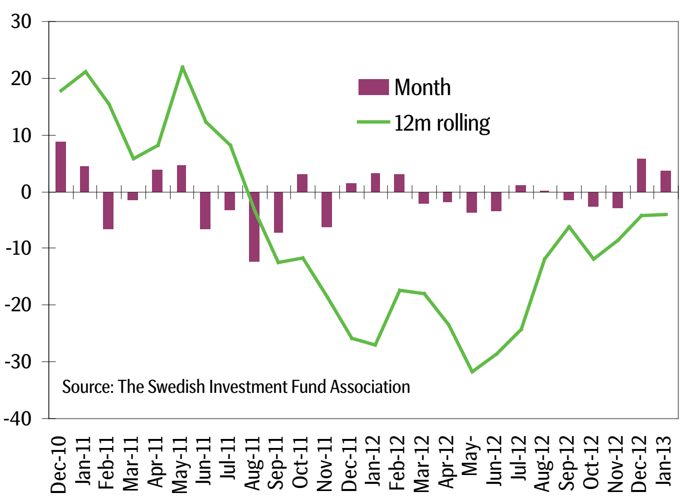
- **Risk of correction**

  These improved fund flows have had a dramatic effect on the stock market so far this year and will continue to do so, but after a rapid upturn there are almost always corrections and one of these will probably materialise very soon.

- **Rising valuations for growth companies**

  Now that the stock market is beginning to be affected by the low return requirements that have dominated the fixed income market for many years, the impact should not be the same for all equities. A general downward adjustment in the return requirement on equity investments will have a bigger impact on value the higher that earnings growth is expected to be.

MUTUAL FUND INVESTORS BUYING EQUITIES AGAIN




*For a long time, investors have been making substantial net withdrawals from equity funds, both in Sweden and internationally. The chart shows net flows into Swedish equity funds that invest in Swedish and Nordic shares in billions of Swedish kronor per month and over the previous 12 months. Equivalent data for global fund flows provide a very similar picture, with large withdrawals in recent years recently having been replaced by significant deposits. We believe that this trend is an expression of reduced worries about systemic financial crises and an effect of historically very low interest rates and yields, which make equities look very attractively valued in a relative perspective.*

WHILE THE RETURN REQUIREMENT ON FIXED INCOME securities has fallen dramatically in the past ten years, there has been almost no impact on share valuations. Low interest rates have had dramatic effects on parts of the real estate market and have generated greater interest in other investment alternatives, but even though equities and bonds have historically been each other's main alternative investment, share valuations have not been affected. The earnings yield, also known as the inverted price/earnings ratio – which shows the level of earnings that listed companies generate on behalf of their shareholders – is at 7 per cent in the Nordic countries today. This is close to the average for the past 15 years. The earnings that shareholders control can either be retained in companies, where they can be used for investments in future earnings or to strengthen the balance sheet, or else be distributed directly to the shareholders. Dividend yield, just below 4 per cent in the Nordic stock markets, is also close to normal, or even somewhat higher than normal, compared to the average during the past decade.

### Paving the way for a lower risk premium

In recent years, stock market indices around the world have soared and plunged with fluctuating investor risk appetite. Worries about new systemic financial crises have abated, however, after vigorous intervention by the world's central banks in recent years to avoid such crises. There have also been significant regulatory changes, aimed at stabilising the financial system. The balance sheets of banks have strengthened dramatically compared to before the Lehman Brothers crash. This has paved the way for a future reduction in the extra risk premium investors demand in order to put their money into equities. Historically normal share valuations and high bond valuations mean that relative valuations of equities are now attracting more risk-tolerant investors to put a larger share of their capital into equities. In our assessment, the sharp upturns in world stock markets over the past few months and the inflows we have recently seen into equity funds are the beginning of a trend reversal that will benefit equities. Investors have probably also begun to adjust their return requirements for equities downward.

### Value of future earnings increases the most

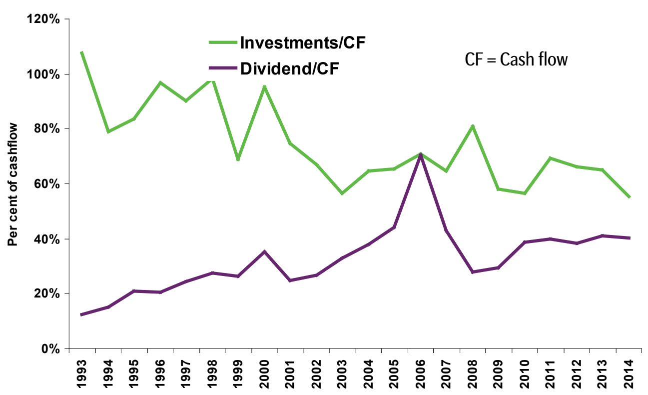
A lower return requirement for equities does not, however, mean that valuations of all shares will increase the same, all else being equal. The present value of all future earnings that companies are expected to generate rises in proportion to the percentage of this value that lies further ahead in time. The difference in the present value of one krona today and ten kronor five years from now will be less in proportion to how much lower interest rate compensation investors require in order to choose the latter alternative. In other words, the shares of companies that generate earnings growth will gain substantially more value than those of companies whose earnings do not grow. The faster the earnings growth, the more present value will be adjusted upward as the return requirement is reduced.

### Plenty of dividends, but a shortage of growth

Ironically, there is an inherent conflict between the tendency in recent years to favour equities with high direct yields and growth prospects. A company that has good growth potential ordinarily needs to retain a larger percentage of its earnings internally in order to make investments needed for growth, while those whose potential to increase earnings by means of investments is more limited are wise to have as generous a dividend policy as possible.

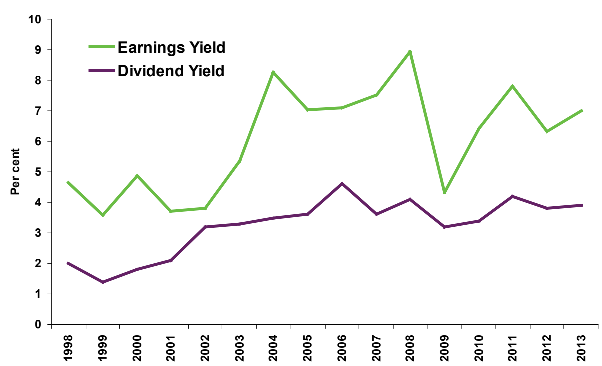
We can also note that in the past two decades, Nordic listed companies have gradually given higher priority to dividends (a larger percentage of the cash flows generated by their operations is distributed to the shareholders), while the percentage of operating cash flows they re-invest has declined. Hardly surprisingly, this also seems to have impacted growth in operating earnings. Because low expected GDP growth in the next few years will also hamper the ability of many companies to find investment opportunities with attractive return potential, we believe that there will be a shortage of companies with good growth prospects. Such companies should see their valuations rise. We expect growth companies to play a leading role in any upturn in share valuations later this year.

### DIVIDENDS ENJOY HIGHER PRIORITY, AT THE EXPENSE OF INVESTMENTS




Source: SEB Markets

### NORDIC EQUITIES ARE GENERATING HISTORICALLY NORMAL RETURNS




Source: SEB Markets

# A good year likely in global stock markets

- **A strong start to the year**

  The positive trend that dominated global stock markets in the second half of 2012 has continued into 2013, with Japanese and US stock exchanges leading the way. Emerging markets started out strongly in January but then slipped, and have performed worse than the developed markets

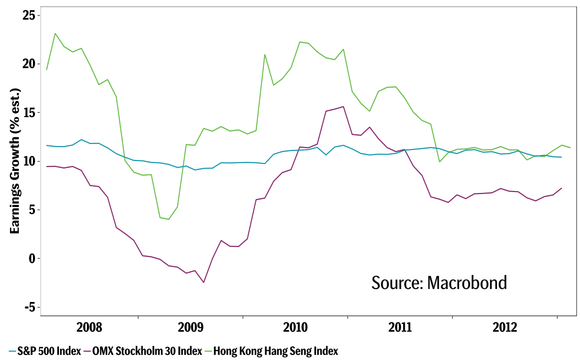
- **Europe playing a bigger role**

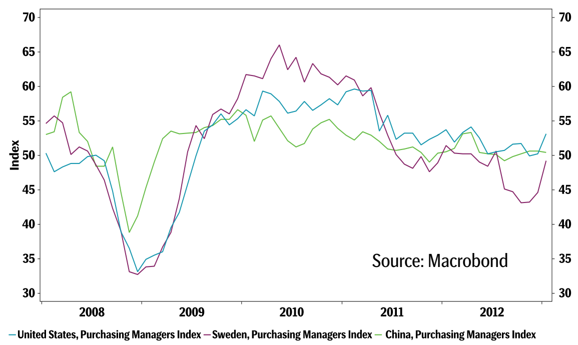
  Macroeconomic data in Germany and the Nordic countries look promising. Well run multinational companies will benefit from a weaker euro and from having a significant portion of their sales in fast growing emerging markets. European small and medium-sized companies have lagged behind the stock market and have rebound potential.

- **We foresee decent performance for equities in 2013**

  A number of factors currently bode well for equities. Record-low interest rates are driving investors to look for higher returns, creating a flow into equities that we have probably only seen the beginning of.

CORPORATE EARNINGS GROWTH AND PURCHASING MANAGERS' INDICES SIGNAL ECONOMIC UPSWING




*Corporate earnings growth and purchasing managers' indices (PMIs) correlate to stock market performance. Companies are continuing to show good earnings growth. If earnings forecasts hold, there is potential for higher share prices. PMIs are heading upward, indicating more positive sentiment among the world's purchasing managers. A figure over 50 indicates expansion in the global economy.*

SUMMING UP 2012, IT WILL GO DOWN IN HISTORY as a very good year for stock markets despite a fair amount of uncertainty rattling the financial market. Anxiety about European debt problems, weak macroeconomic statistics and uncertainty about China's future growth dominated the stock market mood during the first half of the year, with falling share prices as a result. During the summer, we saw growing risk appetite, and prices rose. A brighter macro picture and signs of further stimulus from the US Federal Reserve and the European Central Bank raised hopes. In October, some doubts crept in, due to political uncertainty (the US presidential election and China's leadership change), but December once again saw increased risk appetite, and the year ended on an upbeat note.

The global equities index rose 16 per cent and the emerging market (EM) index rose 17.5 per cent in 2012. The emerging markets showing the greatest advances were India, Hong Kong and Russia. The US stock market rose 15.9 per cent while Europe overall was up 13.8 per cent, with significant variation between countries. The equities index shot up 37 per cent in Greece and 29 per cent in Germany, whereas the Spanish index fell 1 per cent.

### Strong start to the year

The positive trend continued into 2013, and the world's broad indices were generally up in January. The global index (MSCI AC) rose by almost 5 per cent, with the Japanese and US stock markets leading the way. Emerging markets started out very strongly but then slipped, and overall they have performed worse than developed markets. Russia, Shanghai and Hong Kong have posted big gains, whereas Brazil and Taiwan have lagged behind.

US macro statistics were worse than expected in January, while the euro zone showed an improvement. The figures for China and other Asian countries exceeded consensus forecasts. On January 1, the US House of Representatives and Senate passed a compromise budget bill which averted income tax hikes for the majority of American households. Congress also approved raising the statutory national debt limit until May, when new authorisation will be needed. In Europe stock markets were buoyed by the manufacturing purchasing managers' index (PMI). In China too, the official manufacturing PMI signalled expansion, while figures for GDP, industrial production and retail sales were stronger than expected. In Japan the government announced a stimulus package to speed up the country's economic growth.

### Quarterly reports a surprise

Corporate earnings reports for the fourth quarter of 2012 were consistent with expectations, which increases the likelihood of good earnings potential in 2013. Some 65 per cent of US companies reported earnings in line with or better than analyst expectations. Companies in IT, health care and durable goods performed the best relative to expectations.

On a global basis, corporate earnings in 2013 are expected to grow 11 per cent, while the forecast in emerging markets is higher (16 per cent). US earnings growth is projected at 8 per cent, while the figure for Europe is slightly higher at 9 per cent. South Korea, Taiwan, Thailand and Brazil top the list, with earnings expected to rise this year by 17-25 per cent.

Valuations should be considered attractive, even after broad stock market gains, with global equities trading at an overall price/earnings ratio of 13 times forecast earnings for 2013. The US and Japan bring that figure up, with P/E ratios of 14 and 19 respectively, while Europe is trading at 12 times 2013 forecast earnings. Emerging markets are still viewed as cheapest, with a P/E ratio of 11.

Cyclical sectors will show better than average earnings growth for 2013. Companies in commodities, financial services and the industrial sector will see the fastest growth (19, 13 and 11 per cent respectively), but durable goods companies will also show earnings growth of a full 17 per cent. In contrast, defensive sectors such as energy, pharmaceuticals and telecommunications have below-average earnings growth.

### Focus on cyclical and emerging market stocks

The focus has been on defensive sectors, but in our view it is time to increase exposure to cyclical sectors, where earnings co-vary with the general economic trend to a large extent and faster earnings growth is expected. Such sectors are industrials, commodities and consumer goods.

We continue to highlight Asia and emerging markets as attractive investments, given their high growth rates. In addition to China, we have a positive outlook on less developed countries in Asia with significant potential, for instance Indonesia, Malaysia and Thailand. Eastern Europe is also an attractive alternative, with low valuations and high growth, and should be included in a global equities portfolio.

### More European equities in our portfolios

Although sovereign debt problems persist, the clear willingness of political leaders to find solutions favours this trend. Europe is a two-speed continent, with the debt-ridden countries of southern Europe on one hand and a number of healthy economies (Germany, the Nordics) on the other. Macroeconomic data for the second category look much more promising, and well run multinational companies there should benefit from having a significant portion of their sales in growing emerging markets. A weaker euro also puts more wind in their sails. European small and medium-sized companies are attractive investment alternatives, since they have lagged behind the stock market trend.

### 2013 may be a good year for equities

We foresee decent stock market performance in 2013. Earnings growth forecasts of around 10 per cent indicate great potential. At present, a number of factors bode well for equities. Stable macro figures and the willingness of central banks to keep markets liquid provide further positive signals. Record-low interest rates are driving investors to find returns other than through bonds, generating a flow into equities that we have only seen the beginning of. Global listed companies have record-strong balance sheets, and earnings forecasts for 2013 and 2014 look promising. We are in a phase of reasonable company valuations, provided growth forecasts hold.

Offsetting this, however, is continued uncertainty about sovereign debt problems in the euro zone and the US. Questions about the US debt ceiling and fiscal cliff will hang over the market during the spring. The economic recovery rate in China and confidence in the actions of its political leaders are also a cause of concern.

To summarise, we see stock markets trending flat in the short term after a very strong performance in 2012 and into January 2013. although there are some doubts about the strength of the economic recovery. A sustained market rally going forward will depend on growth momentum in Asia and the industrialised counties and on the willingness of political leaders to resolve debt problems. If corporate earnings forecasts are confirmed, it will mean stabilisation and potentially good returns in the world's stock markets for the rest of the year.

# The Country Model

*A company's earnings, its growth and valuation and the market's expectations are factors that affect its stock market performance. It is thus relevant to stay updated on how these factors evolve, both in absolute terms and in relation to other companies. In light of this, SEB Investment Strategy has looked closely at a number of factors that have historically proven to be good guides to stock market performance. Based on this, we have also designed an allocation model, the Country Model, whose purpose is to support the management of global equities.*

The Country Model is a quantitative screening model. It basically consists of a screening of analysts' forecasts of the following factors at companies:

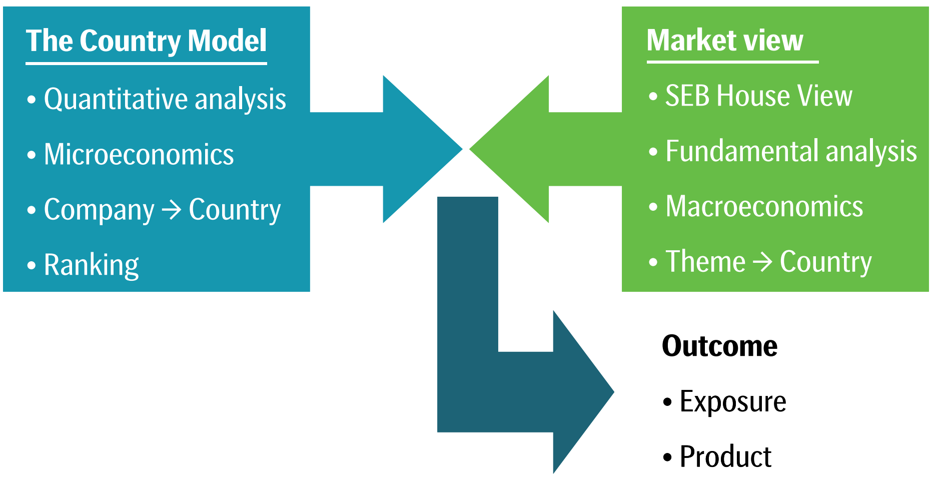
1. Earnings growth
2. Earnings revisions
3. Return on equity
4. Market valuation
5. Dividend

Behind this selection of factors is a study covering the years 2002-2012, where the ability of each factor to provide guidance in choosing shares has been studied. A factor that has generated positive returns and demonstrated continuity in its predictability has earned a place in the model. If a factor has not generated a return or has been too uncertain as an indicator, it has been excluded.

In addition to the analysis of each individual factor, we have also analysed interactions between the factors in the model. If two factors generate excessively similar results, it means that if one of them is wrong the second is probably wrong as well. For this reason, great care has been taken to minimise the co-variation between variables in the model.

The review includes companies worldwide with a market capitalisation exceeding EUR 500 million and monitored by at least six analyst organisations. Companies are scored relative to each other based on each factor, then all of each company's factor scores are added up to yield a total score. Once scoring is done at company level, we create a score at country level as a market-weighted average of all companies with the same domicile. The total country level score is then used to rank the countries.

We have based the model on stock markets, not macroeconomics. In this way, we are better able to capture the exporters in various markets. The model is of course supplemented with qualitative fundamental macro assessments before leading to recommendations or becoming the basis for portfolio allocation decisions.



| TOP THREE | | |
|---|---|---|
| **Ranking** | **Country** | **Reasoning** |
| 1 | Russia | High score for market valuation and earnings revisions |
| 2 | Sweden | High score for return on equity and dividends |
| 3 | Poland | Highest score for earnings revisions and high score for market valuation |
| **RANKINGS FOR MAJOR MARKETS** | | |
| **Ranking** | **Country** | **Reasoning** |
| 5 | South Africa | Highest score for return on equity and high score for dividends |
| 6 | Germany | Relatively high scores for several factors |
| 7 | Indonesia | High score for return on equity and earnings growth |
| 8 | Norway | High score for dividends |
| 10 | Turkey | High score for return on equity and earnings revisions |
| 12 | India | High score for return on equity, low score for dividends |
| 13 | Finland | Low score for earnings revisions |
| 16 | United States | Average scores from earnings revisions and return on equity |
| 17 | China | Average scores for market valuation and return on equity |

Source: SEB

The Country Model is one of several analytical tools that we use when allocating global equity holdings to various countries/regions. To obtain a more holistic view, however, we also need to take into account such factors as risk, market mood, flows and macroeconomic data. Russia ends up at the top in the Country Model, with high scores because share valuations are historically low and earnings estimates were recently adjusted upward. This will result in an overweighting in our aggressive portfolios but not in our traditional portfolios, since Russia is highly dependent on oil price trends and we believe that oil prices will be unchanged in the immediate future. Germany is highly rated in the model. We will happily choose German exporters, which will also benefit from a weaker currency and significant sales to fast-growing emerging markets. The American stock market comes in fairly high in our ranking, but we are choosing a neutral weighting there, since political uncertainty about the debt ceiling and the fiscal cliff will hang over the market this spring.

| REGION | WEIGHT* | REASONING |
|---|---|---|
| **Global** | 1 2 3 4 **5** 6 7 | Equities are reasonably valued, provided that earnings forecasts prove correct. Confirmation is desirable in order to achieve greater stability. Better macro, stable earnings and flows into the stock market will provide good potential. |
| **Europe** | 1 2 3 **4** 5 6 7 | Selectivity! Choose German and Nordic exporters that will benefit from a weaker euro and that have a significant percentage of their sales in emerging markets. Small and medium-sized companies have lagged behind. |
| **United States** | 1 2 3 **4** 5 6 7 | Macro data are relatively stable, which has already led to a strong market. Uncertainty about the debt ceiling and the fiscal cliff will re-emerge. |
| **Asia/EM sphere** | 1 2 3 4 **5** 6 7 | A primary growth investment. Focus on Asia, mainly China but also such less developed countries as Indonesia, Malaysia and Thailand. Eastern Europe is also attractive. |
| **Japan** | 1 **2** 3 4 5 6 7 | The government's stimulus package has led to strong stock market performance and a sharp decline in the currency. |

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

Source: SEB

# The best time for fixed income... was then

- **Wanted: Central bank governor for finance minister job**

  The financial and economic crisis and accompanying public sector deficits have upended the division of labour between fiscal and monetary policy. While public finances are being tightened, central bank governors are now taking over the task of ensuring growth.

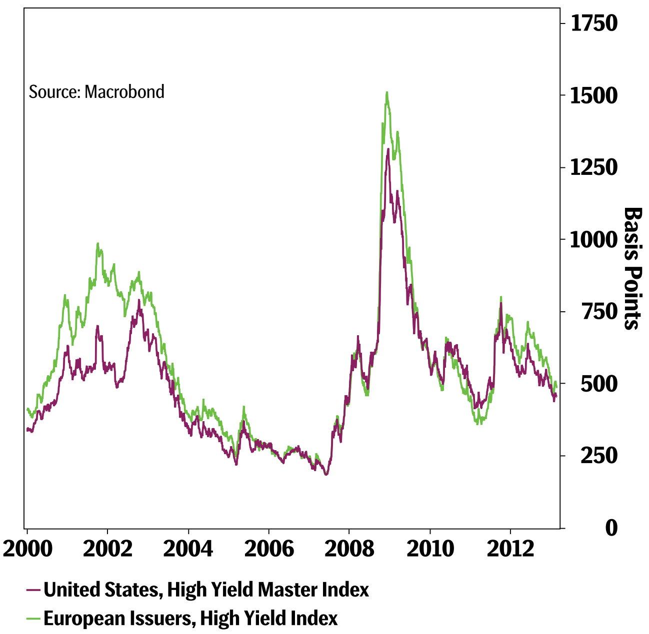
- **The "new monetary policy" benefits the economy and risk assets**

  For at least the next two years, the new focus of monetary policy will benefit the economy, as the risks of a setback to growth diminish. That bodes well for risk asset markets.

- **The best time for fixed income investments ... was then**

  In recent years, government bond yields have fallen rapidly, while corporate bond yields have fallen even more rapidly, which is why fixed income investments have seen large price increases. That era is over. Now is the time to lower expectations.

STABLE SPREADS BETWEEN HIGH YIELD AND GOVERNMENT BONDS IN US AND EUROPE




*Rising government bond yields will probably not widen the spread to high yield (HY) corporate bonds.*
*1) The yield increase is expected to be modest.*
*2) A faster yield increase than expected would probably be the result of an unexpectedly strong economy, which as such is good for HY companies and their bonds.*
*3) In our basic scenario, macroeconomic prospects are favourable, meaning growth high enough to bolster corporate earnings and keep the number of bankruptcies in check, but not so high that inflation and government bond yields will surge.*

FOR A LONG TIME, the main goal of independent central banks was to fight inflation, while fiscal policy was aimed at ensuring employment and economic growth. However, the financial and economic crisis of 2007-2009 upended all that.

First, fiscal and monetary policy measures were adopted on an unprecedented scale to "save" the global economy and its financial system. Once economic recovery began, sharp budget cuts were enacted to reduce gigantic fiscal deficits and slow the growth in government debt.

The role of securing sustained growth was then handed over to monetary policy, which in many countries was dominated by a combination of zero interest rates and expanded quantitative easing (mostly bond purchases). There has thus been a tendency for monetary policy to be "politicised and fiscalised", with central banks such as the Bank of Japan, the US Federal Reserve and the European Central Bank being subjected to political pressure. Monetary policy is therefore well on its way to taking over the role of fiscal policy in ensuring employment and growth, but on top of this the central banks are being forced to accept the risk of higher inflation.

For at least the next two years, this monetary policy revolution will be fairly positive for the economy. The threat of growth setbacks is easing, to the benefit of asset market performance. However, inflation expectations will probably be adjusted upwards a little further ahead. That is one of the reasons why government bond yields in many countries should rise in the long term. Meanwhile, money market rates will remain at historical lows as long as key central bank interest rates remain low – in the US, the euro zone and Britain until 2015 and in Japan probably longer than that.

One argument for higher government bond yields in 2013-14 is that the financial risks in the world have diminished. This and the prospects of healthy risk appetite are cooling investor interest in government bonds. However, bond yield increases will be rather modest. In the short term, inflation expectations look set to remain fairly stable. Actual inflation will remain low for a long time because of extensive slack in the economy, including high unemployment and low capacity utilisation in companies. The danger of inflation driven by monetary easing is likewise low, as long as bank lending does not expand to any appreciable extent.

In 2012, investments in corporate bonds generated a return of around 15 per cent or more in the high yield (HY) segment and about 10 per cent in the investment grade (IG) market. Prospects for 2013 seem much more modest. The yield spread between corporate and government bonds narrowed considerably last year, while yields on government bonds (the denominator in the yield spread) are projected to rise a bit this year. There will thus be very limited room for further increases. This is especially true of IG bonds, which could see small price declines in 2013. HY bond prices are expected to level out during the year as a result of the yield spread narrowing by about as much as government bond yields rise. The return on government bonds would then essentially be equal to the running yield; see table below.

HY bonds, together with emerging market debt, are still the most attractive fixed income investment alternatives. High running yields and the potential for some price increases on EM bonds in conjunction with a slight fall in bond yields bode well for EM debt. In local currencies, expected return could compare favourably with HY; recalculated in OECD country currencies, there is also potential for some foreign exchange gains as well.

| ASSET CLASS | WEIGHT* | EXPECTED RETURN NEXT 12 MONTHS | | | RISK |
|---|---|---|---|---|---|
| | | SEK | EUR | USD | |
| Treasury bills | 1 **2** 3 4 5 6 7 | 0.8% | 0.05% | 0.1% | 1.6% |
| Government bonds | 1 **2** 3 4 5 6 7 | 1.6% | 2.1% | 1.9% | 6.2% |
| Investment grade corporate bonds | 1 2 **3** 4 5 6 7 | 3.0% | 3.0% | 3.2% | 7.3% |
| High yield corporate bonds | 1 2 3 4 **5** 6 7 | 7.2% | 7.2% | 7.2% | 11.0% |
| Emerging market debt | 1 2 3 **4** 5 6 7 | 6.6% | 9.8% | 11.6% | 7.8% |

Source: SEB

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

# Better potential after a tough 2012

- **A difficult year to navigate**

  With strong risk-on/risk-off behaviour in the financial markets, 2012 was a difficult year for hedge fund managers to navigate. This behaviour gradually eased during the fourth quarter of 2012, and 2013 is expected to be a more favourable year for hedge funds in general.

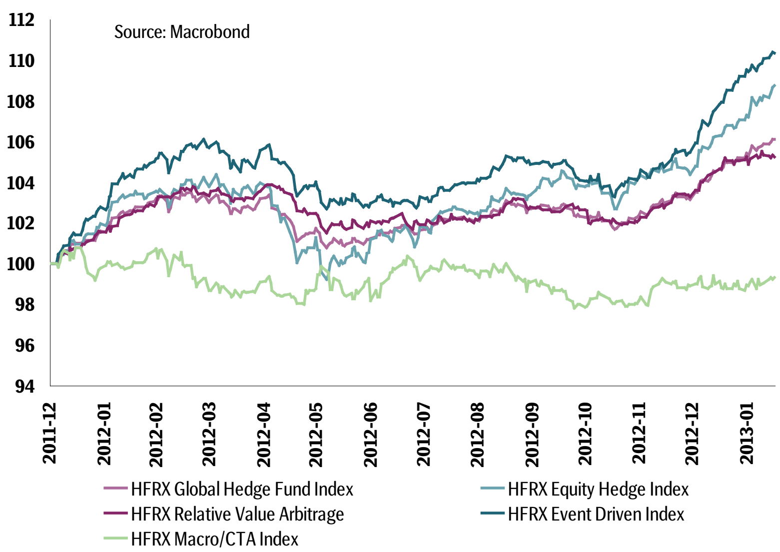
- **Virtually every strategy has better potential in 2013**

  The market's focus is gradually shifting towards company fundamentals and more "normalised" economic conditions and correlations, which benefits Equity L/S and Relative Value. Companies with strong finances and low growth potential should engage in corporate acquisitions, which favours Event Driven.

- **Macro/CTA contributing positive characteristics**

  Discernible trends in the currency markets, among others, bode well for Macro/CTA, and we still believe that CTA (where the manager designs computer models that in turn generate transactions) has a place in investor portfolios given its diversification characteristics. This year we are also hoping for a positive absolute return from these managers.

RETURN POTENTIAL INCREASING AS MARKET CLIMATE IMPROVES




*A "risk-on market" and decoupling from political measures contributed to a positive performance for most strategies in the fourth quarter. Macro/CTA had a tough 2012, but we dare to hope for a more positive performance this year. A more favourable climate points toward hedge funds continuing to generate returns in 2013, although perhaps not as substantial as in the fourth quarter.*

THE FOURTH QUARTER ENDED IN POSITIVE TERRITORY for most hedge fund strategies, led by HFRX Event Driven and HFRX Equity Hedge, with gains of 1.0 and 1.4 per cent respectively. HFRX Macro/CTA turned in the poorest performance, declining by 0.1 per cent for the quarter. Summing up 2012 as a whole, the picture was rather similar, with HFRX Event Driven the best performer (5.96 per cent) and HFRX Macro/CTA the worst (down 1 per cent). The broader overall HFRX Global Hedge Fund Index ended the year up 3.51 per cent.

**Equity Long/Short** had a decent year despite swings between positive and negative sentiment in what became known as risk-on/risk-off behaviour. A number of factors point toward 2013 offering even better potential for this strategy. First, there is a lot of talk about "the Great Rotation", which involves market players taking money from the safest bond markets, given the extremely low yields there, and reinvesting it in instruments like equities, which almost all players are underweighted in, especially in the European market.

Fund managers have generally increased their net exposure to equities, although the rally we saw in January was somewhat surprising. While the consensus outlook seems to be that it is time for a short-term market correction, the message we are getting from our managers is that there are signs of an economic recovery and fundamentals are once again starting to work, which obviously makes things easier for stock pickers – as was the case in January. Although global economic growth is moderate, the stock market is likely to remain decoupled from the economy because of continued monetary stimulus. We still prefer managers with the ability to protect capital, although we are less cautious about managers with a more cyclical style.

**Relative Value** had a good final quarter and a full year that ended up 3.62 per cent. Credit spreads continued to narrow during the quarter, and a dovish stance from the European Central Bank in particular emboldened managers who dared to hold a sizeable exposure until year-end.

We are still positive towards this strategy, especially **Fixed Income Relative Value** and **Credit Long/Short**. After a period of low volatility, there should be greater potential in a market that is somewhat more differentiated and which favours fundamental research to a greater extent. As political leaders are able to shift their attention from crisis management, more local economic prospects should allow profits to be generated on changes in the yield curve.

**Event Driven** rose 1.0 per cent in the final quarter and 5.96 per cent for the full year, making it the best strategy. We have become more positive towards broad mandates, where managers can work with and find potential in a company's total capital structure. Many companies still have good access to cheap loans and have seen their share price jump. Since much of the increase in company valuations stems from a reduction in additional risk premium as the situation in the euro zone has stabilised, market players and corporate executives must focus more on growth potential for companies. So with global economic growth fairly modest, it is not entirely unreasonable to assume increased corporate acquisition activity, creating favourable conditions for fund managers.

**Macro and Trading** had a bad 2012. HFRX Macro/CTA fell 0.12 per cent in the final quarter and 1 per cent for the full year. It was worse for CTA HFRX Systematic Diversified, which lost 2.78 per cent in the final quarter and as much as 7.4 per cent for the full year. As for Macro strategies, the average trend is fairly useless information for investors since there are enormous differences between fund managers. The point here is to have the "right" fund rather than tactically increase or decrease total exposure. Risk-on/risk-off has been a persistent theme in 2012, which ended risk-on, and most would argue that the ECB's moves finally "eliminated" the risk of the euro's demise. Macro managers have been forced to make educated guesses about central bank moves and their consequences and have focused on risk control. CTA funds have not had many good trends or momentum as a basis for their theoretical models. Prospects for the coming year should be somewhat more favourable, since the risk-on/risk-off trend should ease with less action from central bankers/political leaders, which in turn should lead to less correlation between asset classes. Trends like the weakening Japanese yen, Swiss franc and British pound could lead to better opportunities for systematic strategies. We still believe these strategies add positive characteristics to the portfolio, and to top it off we may now possibly see a better absolute return as well.

| STRATEGY | INDEX | PERFORMANCE % (USD) | | | | |
|---|---|---|---|---|---|---|
| | | 2013 YTD | Q4 2012 | 2012 | 2011 | 2010 |
| Global Hedge | HFRX Global Hedge Fund | 2.52 | 0.80 | 3.51 | -8.87 | 5.19 |
| Equity Hedge | HFRX Equity Hedge | 3.75 | 1.37 | 4.81 | -19.08 | 8.92 |
| Relative Value | HFRX Relative Value Arbitrage | 1.60 | 0.79 | 3.62 | -4.00 | 7.65 |
| Event Driven | HFRX Event Driven | 4.16 | 1.01 | 5.96 | -4.90 | 1.98 |
| Macro | HFRX Macro | 0.33 | -0.12 | -1.00 | -4.88 | -1.73 |

Source: SEB

# Trend shift as risk appetite picks up

- **Large transaction volume in the fourth quarter of 2012 may indicate a new trend**

  Globally, transaction volumes increased marginally last year, but the fourth quarter alone accounted for 50 per cent of total transaction volume for the full year.

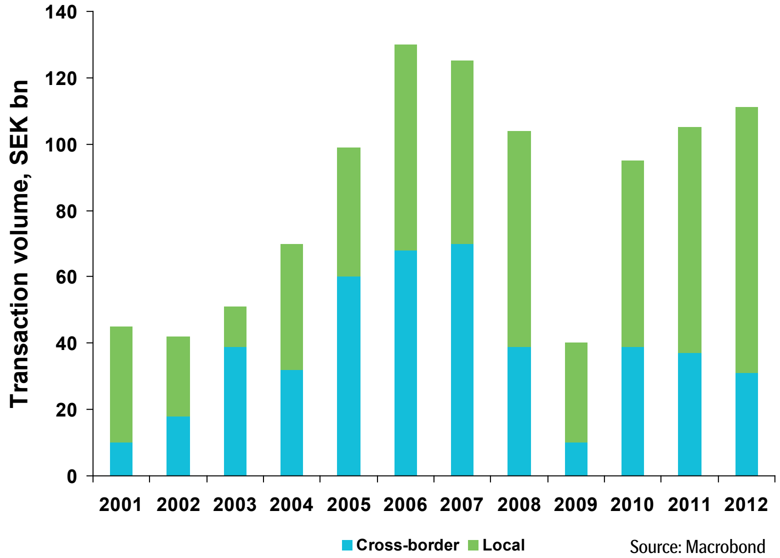
- **Continued strong interest in liquid primary markets**

  As with other risk assets, the real estate market was affected by the fluctuating uncertainty that has dominated the investment climate in recent years.

- **Growing risk appetite bodes well for secondary markets with better returns**

  As the economic recovery continues and risk appetite picks up, more pension funds, institutions and private equity firms will probably allocate a growing share of their holdings to the real estate market.

TOWARDS RISING TRANSACTION VOLUME?




Source: Macrobond

*Transaction volumes increased marginally in 2012, and foreign investor interest declined slightly.*

THE GLOBAL PROPERTY MARKET WAS AMONG last year's winners, and the global REIT index (GPR 250 REIT) ended the year up 23.3 per cent in local currencies. Easing concerns about macroeconomic and political risks, combined with the sustained low interest rate climate, bolstered investment activity – clearly demonstrating investors' growing risk appetite for commercial properties in the fourth quarter. Globally, transaction volume increased marginally last year, but the fourth quarter alone accounted for 50 per cent of total transaction volume for the full year.

As with other risk assets, the real estate market was affected by the fluctuating uncertainty that has dominated the investment climate in recent years. Larger and more liquid markets have attracted the most investor interest, helping push up prices in these so-called primary markets to less attractive entry levels. Liquidity and low volatility, which are key characteristics of primary markets, have enjoyed priority over return. Considering the extremely low returns on government securities today, investors have been forced to look for alternative ways of gaining exposure to safe returns.

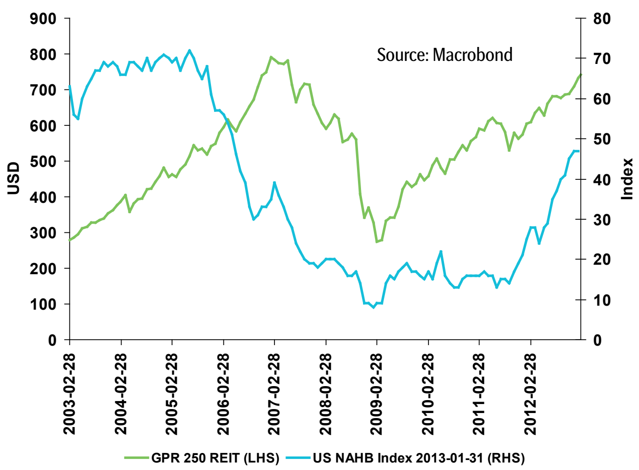
Despite financial worries in the euro zone, the Nordic market continued to show stability. Both demand and transaction volumes managed to avoid the abrupt fluctuations seen elsewhere around the world, despite more limited access to capital and increased risk aversion among banks and investors. Pressure on primary markets in the Nordic capitals has squeezed returns and contributed to a price decline in secondary markets. However, continuing concern in the euro zone's financial markets has meant that a shrinking number of construction projects are being launched for speculative purposes.

Last year, total transaction volume in the Nordic countries increased marginally from its 2011 level. However, volume during the fourth quarter accounted for roughly 40 per cent of the total, which may indicate a significant trend shift. Institutions flush with capital are behind the transactions, both as buyers and sellers. Investors have mostly been interested in residential properties with stable cash flow and office properties in good locations. Their interest in centrally located properties with high occupancy, as in the global real estate market, is an effect of the search for stable returns with low volatility. Properties in the secondary market are thus harder to get funding for, which has also contributed to lower transaction volume. Price differentials between primary and secondary markets have widened, which is also reflected in rent levels.

Although global transaction volume in 2012 increased only marginally compared to 2011, a number of factors point toward stable growth in 2013 , according to Jones Lang LaSalle. As the economic recovery continues and risk appetite picks up, more pension funds, institutions and private equity firms will probably allocate a growing share of their holdings to the real estate market. From a cyclical perspective, there is also reason to believe that continued improvement in risk appetite together with future interest rate hikes could help lead to some reallocation from interest rate risk to properties with stable returns.

The greatest potential is probably in the North American office market, where volume is expected to rise 15-20 per cent during the year according to Jones Lang LaSalle. The US housing market performed well last year, according to the National Association of Home Builders/Wells Fargo Housing Market Index, a monthly measure of builder sentiment. It has been rising without interruption since April 2012 and is now at its highest level since April 2006, clearly an important indication that the conditions for a sustained recovery are in place.

## US HOUSING INDICES LEAD THE WAY




*The trends in the GPR 250 REIT Index and the National Association of Home Builders housing index in the US have been moving in the same direction since mid-2011. However, the NAHB's trend shift in 2005 preceded a similar shift in the GRP 250 REIT Index by about a year.*

# Increased risk-taking bodes well for listed PE

- **Strong market has contributed to higher valuations**

  The index for listed private equity (PE) companies (LPX50TR) ended last year up 28.9 per cent and last autumn's growing risk appetite has continued into the new year.

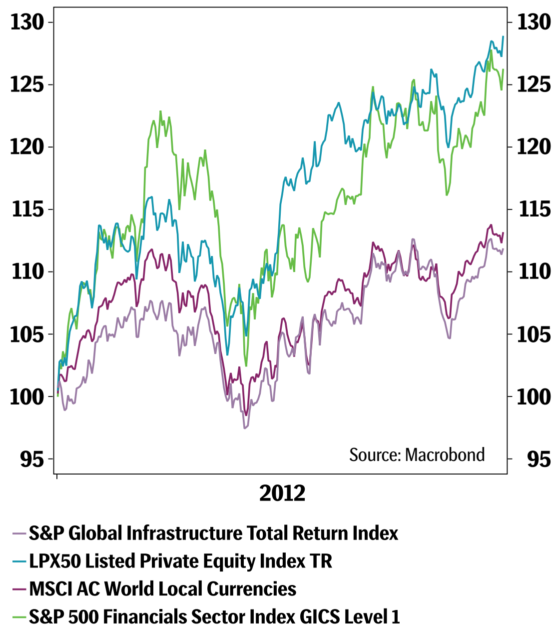
- **Increased risk-taking is contributing to increased activity**

  The growing risk appetite seen last autumn brought more effective pricing, thus creating a window to capture value generated by mature investments.

- **Cautious risk-taking through listed infrastructure**

  Infrastructure investments, with their low beta, have potential to contribute good diversification characteristics and attractive risk-adjusted returns.

STRONG PERFORMANCE FOR RISK ASSETS IN 2012




*Last year was dominated by sharp growth and high volatility for risk assets. The listed PE index was among the winners, along with financial shares. However, calculated for the year, the trend for listed PE companies had a significantly lower standard deviation (12.4 versus 17.0 per cent). During the same period, the index for listed infrastructure had a standard deviation of 11.4 per cent, compared to 10.3 per cent for the broad equities index (MCI AC World in local currencies)*

THE MARKET VIGOUR FIRST SEEN IN MID-2012 shows no sign of ending. In Europe the overall market has been dominated by more restrictive bank funding. High unemployment, combined with high debt levels, has created unwelcome tensions. In the US, worries have centred on the political situation there, with the autumn election and most recently the budget issue as risk catalysts. The problems in the euro zone are far from resolved, but at the moment the market appears to be content with the progress being made. The Citigroup Economic Surprise Index for Europe is at a historical high, which indicates the market has very low expectations for the economic data being reported.

With its recent sharp gains, the stock market has been dominated by high volatility. For traditional equities as well as listed PE, this has meant less precision in pricing, which in recent years has led to generally lower transaction activity. Fewer IPOs, mergers and acquisitions have limited opportunities for PE companies to realise value generated.

However, 2013 has started off well, and in the US a number of major corporate transactions have been registered. These sizeable transactions could be a sign that activity in the financial markets has started to intensify. The growing risk appetite seen last autumn has brought more effective pricing, thus creating a window to capture value generated from mature investments. As a result, many PE companies have recently achieved successful exits.

A pattern of falling discounts to underlying net asset values (NAV) was described in the last issue of *Investment Outlook* (published November 27, 2012). Discounts to NAV sustained since the 2008 financial crisis have hurt this asset class, since underlying value generation has been overshadowed by pricing driven largely by risk aversion. PE companies now increasingly choose to distribute their value generated to shareholders, for instance through share repurchases or portfolio liquidations. It appears that increased activity has started to help reduce these large discounts.

We have previously argued that there is a strong correlation between listed PE and the index for financial shares (S&P 500 Financial Index). Since year-end, the index for PE companies has been one of the strongest performing sectors, and financial shares have shown a similar trend. Last autumn's strong performance brought higher valuations, and SEB Listed Private Equity, for instance, chose to position itself more defensively. So far this year, that cautious positioning has meant the fund is up almost half as much as the broad index for listed PE.

Among listed PE companies, for example, SEB Listed Private Equity allocates its private equity exposure through listed PE portfolios, publicly traded companies controlled by PE firms and listed management companies. Recently, the trend has been strongly driven by what are called special situations, which arise through direct investments in publicly traded companies controlled by PE firms. PE firms identify vulnerable companies where they have a good chance of turning around the profitability of the business by reviewing factors like cost structure, product range, distribution, marketing or pricing strategy. As a rule, this type of holding is more decoupled from general market movements (lower beta) than, for instance, listed management companies.

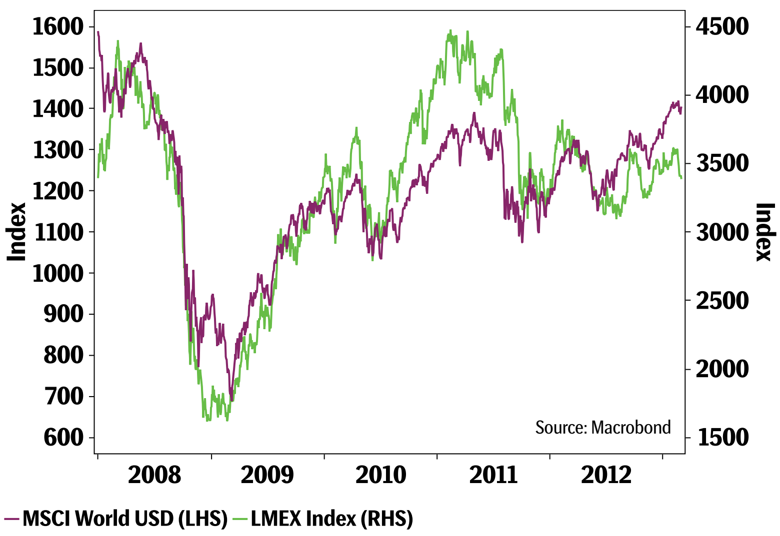
If an investor wants to cautiously increase portfolio risk, listed infrastructure is an attractive option. Infrastructure can be broken down into four broad categories – transport (toll roads and airports), equipment (such as power transmission and distribution), communication and social infrastructure (such as hospitals and schools).

Infrastructure assets are characterised by their high capital intensity and long service life, which also helps create significant barriers to market entry. These characteristics give the asset a defensive return profile in terms of sensitivity to business cycles, and also offer some protection against inflation since many infrastructure assets use indexed fee structures. With their low beta potential, infrastructure investments contribute good diversification characteristics and attractive risk-adjusted returns.

# Metals – greatest potential in the asset class

- **Better economic conditions mean increased demand**
  Macroeconomic statistics from China and the United States have improved, and the situation in the euro zone is less stressed. These two factors bolster our view that the global economy will accelerate slightly this year. Improved economic conditions, although only marginally better, should increase the demand for commodities.
- **Dependence on China may potentially change**
  The price trend for metals has been entirely dependent on economic growth in China in recent years since the country consumes half of global production. This situation could potentially change somewhat since metal consumption in Europe seems to have bottomed out and there are signs of economic recovery in the US.
- **Lower prices should fall even further, at least in the long term**
  Grain prices have trended downward since their strong rally last summer. Despite the decline, prices are still not low and in our view should fall further, although current weather conditions in the US have the potential to disrupt this trend in the short term.

METAL INDEX AND GLOBAL EQUITIES, FIVE-YEAR PERFORMANCE




*Historically, metal and global equity prices have correlated fairly well, which is logical since the same factors largely drive the two trends over time. This pattern was disrupted in 2012, when equities performed well while metal prices (London Metals Index) failed to make similar gains. The main explanation for this was anxiety about China's growth. A recurring theme was whether the country was headed for a hard or soft landing, which weighed down Chinese equities and metal prices in 2012. An accelerating Chinese economy, which is our forecast, could lead to rising metal prices.*

IN 2012, BASE METAL PRICES did not follow their historical pattern and rise with global stock markets. Worries about economic growth in China weighed down prices, which is logical since the country consumes half the world's metal production. However, there were positive signals of strong growth from that country toward the end of the year. The purchasing managers' index (PMI) and other indicators now suggest brighter times ahead in China and other key parts of the world. Prices have not been restrained relative to marginal production costs, and demand appears to have stabilised in most markets. In Europe and the US, demand has been weak since the 2008 financial crisis, and the price trend has depended on growth in China. In 2013 there is potential for change; in Europe the deceleration in metal consumption seems to be at an end, and in the US there are signs of a relatively stable recovery. In our view, base metals are the commodity group with the greatest potential for rising prices in 2013.

## Automotive industry lifting precious metals

Our assessment was that the third round of the Federal Reserve's monetary stimulus programme (QE3) in the US and steps taken by a number of other central banks would lift gold prices above their nominal record, but that did not materialise. Gold has been trading at around its average price for about the past year and a half. Market players are more focused on a global recovery than on the risks of a slump, which should keep gold prices in check. We expect slightly lower gold prices during the year unless there is a sharp rise in inflation expectations, which we see no signs of. If global growth were to show surprising strength while inflation remains low, that could lead to a sell-off in gold, since investors would look for return potential elsewhere. The prospects are brighter for platinum and palladium. About 50 per cent of production of these precious metals is used in the automotive industry, for catalytic converters. Palladium is used in petrol engines, so the price trend depends largely on economic growth in China and the US, while platinum is used in diesel engines, which are more common in Europe. Roughly 70 per cent of platinum is produced in South Africa, where major supply disruptions have hit production in the wake of violent strikes. Palladium and platinum mines have also closed due to poor profitability.

## A dry US could threaten the falling price trend

Grain prices have continued to fall since their strong rally last summer, completely in line with our predictions. There are no expectations of extreme weather conditions caused by the likes of La Niña or El Niño, so we anticipate lower prices in 2013. However, there is the risk of a price correction in the short term, due to unusually dry weather conditions in the US. There is also little incentive to sow if no rain falls before the planting period for maize (corn) and soya beans gets under way in March.

## Lower demand offset by reduced supply

From October to December last year, the Saudis slashed oil production by 600,000 barrels per day to offset the drop in demand. That raises hopes of a further production cut now that some 1.5 million fewer barrels per day are needed on a seasonal basis to balance the market during the first half of the year. Prices will probably be restrained in the short term by the risk of Saudi Arabia not cutting production at a desirable rate and by increased production in the US, driven by shale oil. Meanwhile, market players are increasingly optimistic about a global economic recovery, which is reflected in stock market performance in late 2012 and early 2013 but not in oil prices. In our view, oil prices will still be around today's levels one year from now, with an upside risk if instability intensifies in the Middle East, especially in Iran.

| ASSET CLASS | WEIGHT* | REASONING |
|---|---|---|
| **Energy** | 1 2 3 **4** 5 6 7 | We believe oil prices will be trading at current levels a year from now. There is some seasonally related downside risk in the short term unless Saudi Arabia cuts production at a desirable rate. |
| **Industrial metals** | 1 2 3 4 **5** 6 7 | In our view, this category of commodities has the greatest potential to trade higher a year from now. Nickel is the metal currently trading furthest below marginal production cost, which limits the downside risk, but our outlook for copper, aluminium and zinc is also positive. |
| **Precious metals** | 1 2 **3** 4 5 6 7 | We expect lower gold prices unless inflation expectations rise appreciably. However, palladium and platinum have upside potential, since about 50 per cent of production goes to the automotive industry. |
| **Agriculture** | 1 **2** 3 4 5 6 7 | We believe continued price declines are most likely. However, there is a short-term risk of a correction as a result of unusually dry weather in the US, which could disrupt the planting of maize and soya beans. |

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

# Currencies as an economic policy weapon

- **Ammunition for a verbal currency war**

  The unprecedented accommodative monetary policy in the OECD countries, combined in Japan's case with a weak-yen policy, means stronger currencies, export losses and financial imbalances in emerging markets (EM). These countries have responded with verbal intervention but also tangible action.

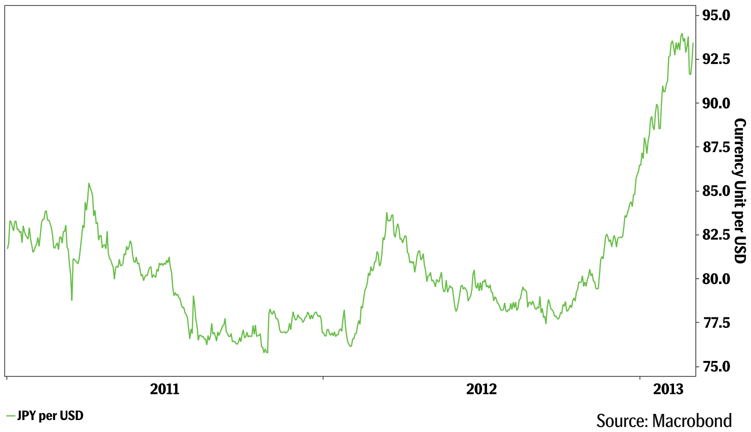
- **Attractiveness gap narrowing between alternative and classic reserve currencies**

  Diminishing financial risks in the euro zone and US as well as growing risk appetite has brought a slight cooling of interest in alternative reserve currencies like the SEK, NOK, AUD, NZD and CAD, whereas the EUR has attracted more interest. In contrast, the JPY and to some extent the CHF have been on a downhill slide.

- **Many EM currencies are high in SEB's ranking**

  Strong financial balances, rapid economic growth, high interest rates, prospects of good risk appetite and OECD monetary policies are arguments favouring an increased rise in the value of EM currencies against the currencies of OECD countries.

### "ABENOMICS" HAS CAUSED THE YEN TO LOSE STRENGTH




Source: Macrobond

*The yen has long been considered one of the most overvalued OECD currencies, hampering Japanese exporters and contributing to deflation – a general decline in prices. However, the new Shinzo Abe government's measures to jump-start the economy with aggressive monetary and fiscal stimulus – "Abenomics" – has caused the yen to weaken. The aim is to boost Japanese growth and shift from deflation to inflation. In line with this, we expect a further drop in the yen, including against the US dollar.*

CURRENCIES BACKED BY STRONG economic fundamentals – current account surpluses and orderly public finances – have been attractive in the aftermath of the global financial and economic crisis. These include the NOK, SEK, AUD, NZD and CAD, which are known as alternative reserve currencies.

The classic reserve currencies consist of the USD, EUR, GBP and JPY, which were hit by capital outflows when economic and financial problems in these countries escalated and monetary policy became increasingly expansionary. Capital has shifted to a large extent to alternative reserve currencies as well as to the CHF. The Swiss currency appreciated so much in 2011 that the Swiss National Bank (SNB) introduced an exchange rate cap against the EUR of 1.20 in September that year.

This flight to alternative currencies now appears to have lost momentum to some extent. There are several reasons. Lower global financial risks and the accompanying upswing in risk appetite are beginning to reduce the attractiveness of alternative reserve currencies as "safe havens". Moreover, the values of some of these currencies have risen, while key government interest rates have been cut and bond yields have fallen in those countries. However, the **NOK** and **SEK** in particular appeal to many investors – although perhaps not as much as before – and are therefore expected to rise in value against many other currencies in 2013. Growing risk appetite and increased global economic strength bode well for these Nordic currencies. The commodity currencies **AUD** and **NZD** also have potential to appreciate, but to a lesser degree.

Emerging market currencies have risen due to economic and financial strength in Asia (excluding Japan), Latin America and Eastern Europe as well as the monetary policies being implemented in the OECD countries. The latter countries have triggered strong emotions, giving rise to the expression "currency war." In any event, EM currencies have the potential to continue rising in value, as reflected in SEB's FX Scorecard below.

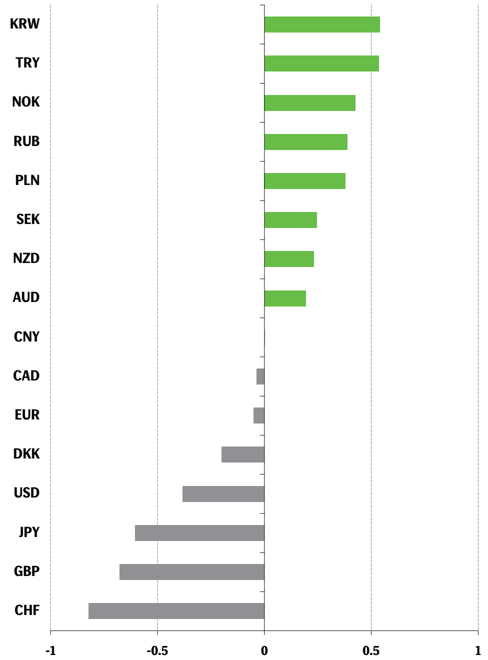
Two currencies which showed considerable downward movements last year are the **CHF** and especially the **JPY**. When there were serious worries about the financial crisis in the euro zone, a lot of capital flowed into Switzerland. The **CHF** became undesirably strong in the SNB's eyes (see above). With this financial stress having eased, capital flows are now returning to the EUR, which is why the CHF has depreciated significantly. Assuming there are no major setbacks in euro zone risk management, the CHF will decline further in value against the EUR by the end of 2013.

The striking decline in the **JPY** is explained by the new Japanese government's highly aggressive fiscal and economic policies, together with its explicit aim to lower the value of the JPY (benefiting exports and allowing inflation to be imported, one way to fight deflation in Japan). Our forecast is that the JPY will continue to weaken.

During the first half of 2013, the **EUR** may strengthen a bit against the USD. Nonetheless, later this year and in 2014 there is potential for the USD to take revenge as US growth accelerates and the Federal Reserve nears the end of its bond purchase programme (now USD 85 billion/month). Increased financial risks and setbacks in the process towards a European political union could at times weigh down the EUR.

The **GBP** has long been a surprisingly strong currency, last year in part due to capital outflows from an anxious euro zone. However, there are strong arguments favouring a weaker GBP, including large British trade deficits, negative financial capital flows and Moody's recent credit rating downgrade.

## SEB FX SCORECARD




| CURRENCY CODES | | | |
|---|---|---|---|
| KRW | South Korean won | CNY | Chinese yuan |
| TRY | Turkish lira | CAD | Canadian dollar |
| NOK | Norwegian krone | EUR | Euro |
| RUB | Russian rouble | DKK | Danish krone |
| PLN | Polish zloty | USD | US dollar |
| SEK | Swedish krona | JPY | Japanese yen |
| NZD | New Zealand dollar | GBP | British pound |
| AUD | Australian dollar | CHF | Swiss franc |

*Each currency is given a weighted score based on ten different parameters – economic fundamentals, interest rates, monetary policy, flows, positioning, technicals, liquidity, event risk and global cycle – as well as SEB's subjective assessment of the relevance of the different parameters as driving forces in the currency market over the next six months. The outlook for relative currency strengths in the coming 3-6 months (see chart at left) is taken from our latest Currency Strategy report, dated January 2013.*