Investment Outlook

PRIVATE BANKING • INVESTMENT STRATEGY

Market hopes will require some evidence

DECEMBER 2013

SEB

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Market hopes will require some evidence

World economic growth is poised to accelerate. This will happen slowly, and right now market hopes are ahead of the evidence in many cases. To some extent, stock markets are celebrating victory too early.

The stock market is often said to be an economic indicator that is 6-8 months ahead of the real economy. If, for a moment, we allow the real economy to be represented by company earnings forecasts, it appears the latter are largely standing still while share prices rise, so the saying seems true. For sceptics, this is a bit too exciting; the market has ended up in a limbo, where hopes are expressed in share price movements and real economic developments in terms of earnings. For good reasons, the gap can make many people nervous. We analyse this further in our Nordic equities text.

With their rapid growth, emerging markets have been an investment theme for a long time. Today the picture looks different. The BRIC concept is breaking apart, leaving a lone but powerful C...

The potential for emerging market (EM) investments is about to change. The recovery phase we are now experiencing is of a slightly different nature than previous ones. After the 2008 financial crisis, the recovery was led partly by China's sharp increase in capital spending – a continuation of the economic upturn that drove commodity prices throughout the early 2000s. Heavy infrastructure investments in developing countries were among important factors behind the economic upturn.

One can say that we have gone through three phases in EM history. The first phase lasted until 1997-1998 – with rapid economic build-up, outsourcing of production to new countries and rapid industrialisation – and led to weak government finances and a financial crisis that caused severe problems in Russia and parts of Asia.

The next phase – with its rapid expansion of heavy commodity-intensive capital spending – also created a degree of financial vulnerability in terms of trade flow imbalances, current account deficits and so forth for some countries.

Today we are in a more mature phase. We will not see the same rapid expansion or the same pressure on the commodity sector. We have reached a phase where we can no longer speak of EM economies as one unit. Instead, each country and its currency and stock market must be evaluated on its own merits. This is why we have written a theme article about how BRIC is perhaps "only" a C nowadays.

The late 1990s and early 2000s gave us one of the biggest market bubbles in history, the IT (or dotcom) bubble. What has happened since then? Young, rapidly growing, innovative companies that provide ways of typing 160 characters on a computer and are valued in the billions of dollars are now part of our reality, and this needs to be managed and evaluated.

We have looked more closely at the "new" economy. Its growth is very strong, and unlike the period around the turn of the millennium, is sustained by changes in consumer behaviour patterns. Today it is natural for us to consume, be entertained and manage our day-to-day finances via the Internet and the channels available there. New brands with an extremely wide reach and in many cases extreme profitability are being created regularly. In a theme article, we look more closely at these phenomena and the forces driving them and discern what may be real values in this new world.

There is plenty to think about today. Some old patterns are intact; some new ones are appearing. No era is identical to another, even though there are obvious similarities. Together, innovation and needs generate growth and value – eternal forces that we can reflect on and identify, while waiting for the economy to catch up with equity valuations.

HANS PETERSON
Global Head of Asset Allocation

Markets being sustained by good liquidity

In a simplified analysis, three things are needed to drive a market: economic stability, preferably with a positive tilt; a good supply of liquidity; and reasonable valuations. Today's markets are largely driven by a very good supply of liquidity and forecasts of better economic conditions. This, in turn, is driving up valuations in many cases, but the current high valuations have not significantly undermined the stability of the stock market, which says a lot about how strong the liquidity situation is. After the US Federal Reserve (Fed) and its chairman-designate Janet Yellen further reinforced their commitment to continuing quantitative easing (QE), the markets have enjoyed even more support and the upward trend is intact. This trend has some special characteristics, however.

We predict the best performance for assets with low sensitivity to economic cycles, equities with stable earnings and – as an alternative to these – corporate bonds that provide returns. More cyclically sensitive markets, such as those in EM countries, are lagging behind to some extent. This performance pattern will probably continue until we see clearer evidence of improved economic conditions, and/or the Fed communicates a new direction for its stimulative QE programme.

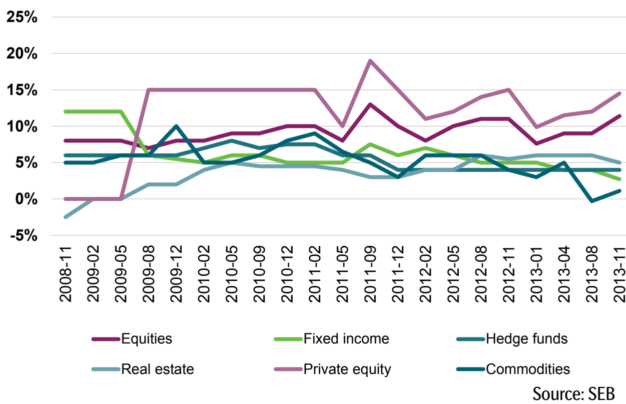
EXPECTED RISK AND RETURN IN THE NEXT 12 MONTHS

Our risk and return expectations are taken from the SEB House View and are based on our macro scenario (see page 16). These expectations cover the next 12 months.

ASSET CLASS	EXPECTATIONS NEXT 12 MONTHS		COMMENT
	RETURN	RISK	
EQUITIES	11.5%	10.5%	Expected risk and total return for global equities, measured using the MSCI All Country World Index in local currencies.
FIXED INCOME Bonds Cash	 2.5% 1.0%	 4.0% 0.0%	The forecast refers to an average duration of 5.5 years (T-bonds 7 years and high yield 4 years). In this case, cash equals assets with risk-free returns, for example T-bills.
HEDGE FUNDS	4%	4%	The risk and return forecast is based on the HFRX Market Neutral Index.
REAL ESTATE	5%	12%	The risk and return forecast is based on the EPRA Index.
PRIVATE EQUITY	14.5%	13.6%	A beta adjustment of global equities, measured as the performance of the LPX Total Return and MSCI AC World LOC indices over the past seven years.
COMMODITIES	1%	9%	Expected risk and total returns for the Dow Jones UBS Commodity Index with weightings as follows: energy 33%, industrial metals 19%, agriculture 36%, precious metals 13%.
CURRENCIES	N/A	N/A	Used as a source of returns in our asset management. Our forecasts (12 months ahead) for the most central currency pairs are: EUR/USD 1.25 (-7.1%), EUR/SEK 8.40 (-6%) and USD/SEK 6.72 (+1.1%).

Source: SEB

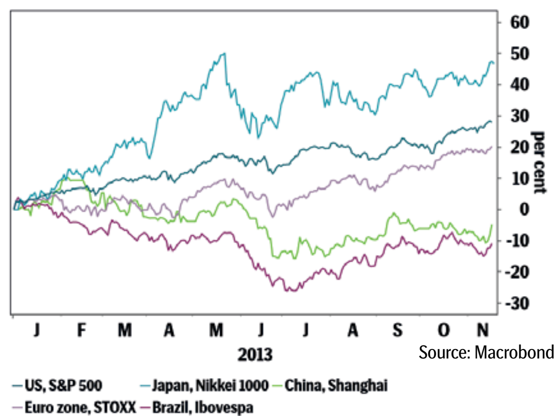
CHANGES IN OUR EXPECTED RETURNS



Source: SEB

Since the last issue of Investment Outlook *(published September 17, 2013) we have made adjustments mainly for currencies. We use the asset class as a source of returns but no longer issue forecasts for the class itself, although we provide forecasts for the most important currency pairs.*

STRONG LIQUIDITY SITUATION DRIVING WORLD EQUITIES



Source: Macrobond

The upward trend in the world's stock markets will persist. The pattern is that markets with low dependence on economic cycles are the strongest performers, while commodity-dependent, cyclically sensitive markets such as China are lagging behind.

MAIN STRATEGIES IN OUR PORTFOLIO MANAGEMENT

- **Looking ahead, economic performance will be consumer-driven**
  We will not have the same type of capital spending-driven economic growth as before. Consumer demand will be a driving force, which will shift the focus to well-diversified stock markets and countries.
- **When the Federal Reserve (Fed) reduces its monetary stimulus, conditions will change**
  All phases during which the Fed adjusts its monetary policy will change financial market conditions, especially bond markets and currencies. May 2013 was the dress rehearsal, and after New Year it will probably be time once again as "tapering" of QE is implemented. Yet a phase-out of stimulus programmes is fundamentally a confirmation of growth.
- **Capital spending growth is slow and should accelerate**
  We have seen a slow increase in capital spending recently, while the needs of businesses and private individuals have probably not diminished, but have actually built up. For markets that have investment-intensive industrial firms, this may be an interesting card to play next year.
- **US has built up high market valuations – more action in China**
  The market is discounting an economic upturn, and this is driving market prices rather high, especially in the US. Earnings there were also acceptable in the third quarter. A reasonable pattern today is that the focus will shift to Europe and parts of Asia (China), since they will benefit from increased trade and will show improving earnings growth.
- **The positive trend will boost the potential of hedge funds**
  There is a great continued need to offset equity holdings in portfolios, and given today's ultra-low interest rates the bond market has become less attractive. Interest rates should move upward. We will probably need to use hedge funds to offset portfolio risks. The focus will be on hedge fund strategies that are based on strong underlying markets.
- **Basically we are in the midst of a long-term equity phase**
  Given low interest rates, stronger economic fundamentals and the somewhat improved US debt situation, the stock market will be the primary source of returns for a long time. It will be volatile, and in some cases valuations are becoming conspicuously high.
- **Foreign exchange markets will provide opportunities**
  FX market volatility is increasing. The USD should strengthen as the Fed tapers its QE. Some emerging market currencies have become vulnerable. The JPY can fall further. We foresee combinations here that make the FX market attractive.

ASSET CLASS	WEIGHT*	REASONING
Equities	1 2 3 4 **5** 6 7	Looking ahead, equities will benefit from synchronised global growth and positive flows. Equity valuations have risen and we need confirmation of growth in the form of higher earnings to achieve a continued upturn. Our portfolios will focus on Europe and Asia – regions with lower valuations than the US market. Given the high percentage of cyclical companies, their exchanges should perform well when the economy gains momentum.
Fixed income	1 2 **3** 4 5 6 7	Historically low interest rates/yields on developed market (DM) treasury bills and bonds make these government securities unattractive for investors seeking returns. The high yield (HY) market and emerging market debt (EMD) offer substantially higher running yields. Taking the risk picture into account, HY is much more attractive than EMD.
Hedge funds	1 2 3 **4** 5 6 7	Increased risk appetite and decreased correlations between asset classes have created better potential for hedge funds to generate returns. This environment will benefit strategies based on fundamental analysis, but also relative value and event-driven strategies. Improved general economic conditions will also support macro strategies.
Real estate	1 2 **3** 4 5 6 7	We have a fundamentally positive view of real estate, but taking into account the recent increase in interest rate sensitivity and the shortage of investment alternatives, we are wary about this asset class.
Private equity	1 2 **3** 4 5 6 7	During 2013 the transaction market has continued to improve, helping more and more PE companies cash out of mature portfolio companies. Partly because of its strong connection to the financial services sector, we have a favourable view of this asset class.
Commodities	1 **2** 3 4 5 6 7	Commodities will have limited return potential during 2014. Industrial metal prices have the biggest upside potential, but the slope of the forward curve will reduce this. We expect no dramatic oil price changes, but geopolitical trouble spots could possibly affect prices sharply.
Currencies	1 2 **3** 4 5 6 7	The major currencies – the USD, EUR and JPY – are driven mainly by the monetary policies of their central banks. Massive asset purchases by the Bank of Japan will weaken the yen and further easing by the ECB will lower the euro, while Fed policy will keep the US dollar weak at first, then help to strengthen it.

Source: SEB

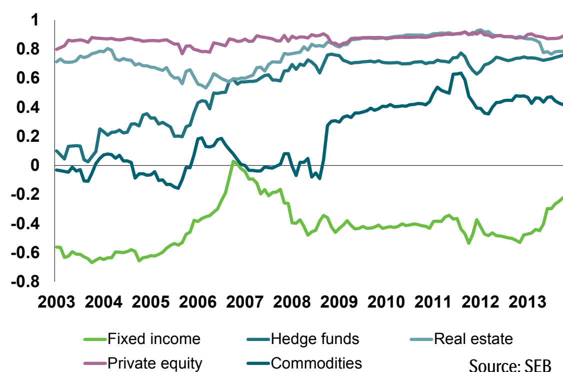
** "Weight" shows how we currently view the asset class as part of a portfolio. Level 4 is a neutral situation. These weights are changed continuously, based on our tactical market view, and may thus diverge from our long-term strategic view of an asset class. At customer level, portfolios are tailored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

HISTORICAL CORRELATION (NOV 30, 2003 TO OCT 31, 2013)

	Equities	Fixed income	Hedge funds	Real estate	Private equity	Commodities
Equities	1.00					
Fixed income	-0.32	1.00				
Hedge funds	0.70	-0.33	1.00			
Real estate	0.83	-0.09	0.57	1.00		
Private equity	0.87	-0.29	0.70	0.87	1.00	
Commodities	0.35	-0.22	0.67	0.30	0.41	1.00

Source: SEB

ROLLING 36-MONTH CORRELATIONS VS . MSCI WORLD



Source: SEB

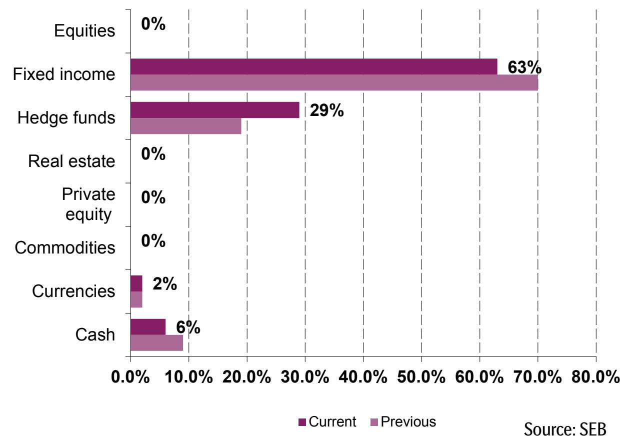
Historical values are based on the following indices: Equities = MSCI AC World EUR; fixed income = JP Morgan Global GBI EUR; hedge funds = HFRX Global Hedge Fund USD; real estate = SEB PB Real Estate EUR; private equity = LPX50 EUR; commodities = DJ UBS Commodities TR EUR.

MODERN INVESTMENT PROGRAMMES

– ALLOCATION OF CAPITAL ACROSS ASSET CLASSES AT THREE RISK LEVELS

MODERN PROTECTION

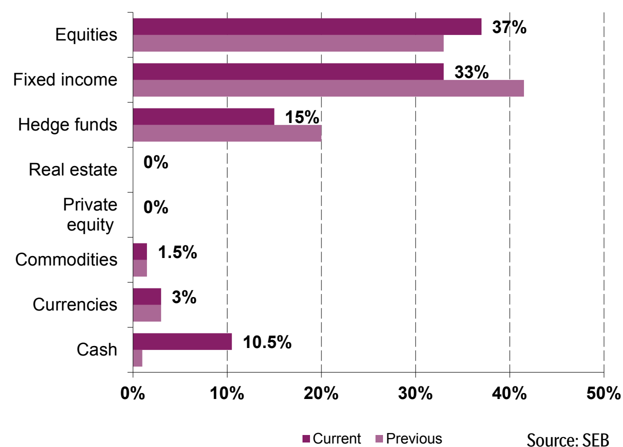
Because of today's ultra-low interest rate environment, for example with German two-year government bonds at 0.1 per cent, we must take risks in order to keep returns at the level of inflation. Given the continued risk of rising interest rates, the focus is still on interest rate neutral investments. Absolute Return fixed income managers had difficulties navigating the tapering worries of last May. At this writing we are reducing our Absolute Return allocation from 35 to 26 per cent of the portfolio. Instead we are investing in Credit Long/Short hedge funds, which do not focus on relative interest rate movements, but more on fundamental corporate and government loans. In high yield, we have minimised interest rate sensitivity by divesting "normal" high yield (2.5 per cent), and this set of holdings now consists only of short duration high yield bonds and leveraged loans (11.5 per cent). We have also sold our Asian currency exposure (2 per cent).



Source: SEB

MODERN GROWTH

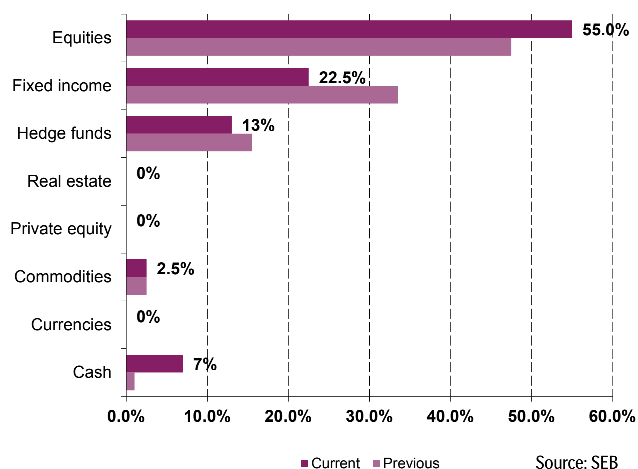
Although tapering is not an immediate threat to risk assets, the smallest hint of QE phase-out will have financial market consequences. The effects are difficult to foresee, but assets that were hurt by the latest tapering worries will probably face another tough period. This will mean rising yields, a stronger USD and weaker EM currencies. In Modern Growth, we have continued to decrease interest rate risk by reducing "normal" high yield from 10 to 2 per cent of the portfolio, as well as selling EM debt (2 per cent) and Asian currency (2 per cent) holdings. Meanwhile we are looking at "new" asset classes that may provide equivalent return flows but are less correlated, such as catastrophe bonds. This autumn we have gradually increased our cyclical exposure, especially by purchasing European equities, which now total 11 per cent of the portfolio.



Source: SEB

MODERN AGGRESSIVE

This autumn we have worked to make Modern Aggressive a more dynamic portfolio. As a first step, we have begun to take more tactical positions in Europe via ETFs. Equities now account for 55 per cent of the portfolio, of which exposure to Europe is 14 per cent of the portfolio. As in the other programmes, we have also minimised interest rate risk by divesting "normal" high yield and reduced currency risk by divesting EM debt. There is room for more risk-taking in the portfolio as a whole, but for the time being we are tactically cautious. Cash is temporarily high due to ongoing analysis of "new" asset classes such as catastrophe bonds.



Source: SEB

From BRIC to C

The term BRIC was coined over a decade ago, allowing analysts and investors to train their spotlight on the four largest emerging market economies. An ever-growing number of BRIC funds were launched in the market. But how relevant is it today to lump together these four stock markets? Not so relevant, our analysis shows, since economic conditions in the BRIC countries in 2013 seem highly divergent.

Once upon a time at the turn of the millennium, a group of emerging market (EM) countries were christened by the then chief analyst at Goldman Sachs, Jim O'Neill, with the acronym BRIC in his analysis "Building Better Global Economic BRICs". The common denominator for these four countries – Brazil, Russia, India and China – was that they topped the list of EM economies in gross domestic product or GDP (adjusted for purchasing power parity, PPP). Otherwise, there were not many similarities between the countries – economically, socially or politically.

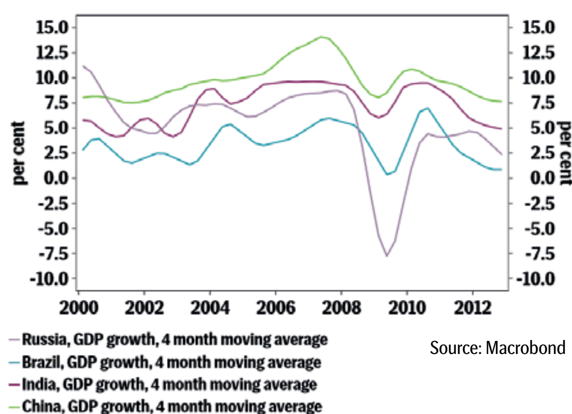
Since 2001, when O'Neill coined the term BRIC, the four countries' share of global GDP has increased from just over 23 per cent to almost 29 per cent today. China's economy has grown the fastest during this period (GDP is up 272 per cent), followed by India's (147 per cent), Russia's (93 per cent) and Brazil's (62 per cent). Compared with the forecasts that Goldman Sachs published over a decade ago, GDP growth in China and India has been surprisingly strong, whereas the Russian and Brazilian economies have expanded more slowly than expected. Economic growth in the BRIC countries during this period has varied in terms of structure and driving forces. However, one feature they share is that every production factor – especially productivity but also real capital (capital spending) and labour – has made a significant contribution.

The BRICs' rapid advance has had a clear impact on the global economy. During the first decade of the millennium, many commodity prices surged in the wake of increased demand, as China in particular expanded its infrastructure on a large scale. This benefited commodity-producing EM countries such as Brazil and Russia, as well as many African economies.

Accelerating industrialisation in low-cost EM countries, with some of the BRICs leading the way, resulted in faster job creation. From 1980 to 2010, the number of non-agricultural jobs grew by 900 million in the EM sphere, compared to 160 million in the developed market (DM) sphere. This trend also led to a growing price and cost squeeze on manufactured goods. The global competitiveness of EM economies improved significantly, and they took good advantage of the opportunities provided by world trade. This was reflected in growing EM trade surpluses at the expense of DM countries. The BRICs' share of world trade increased from 6 per cent in 2000 to 15 per cent in 2010.

The growth rate in the BRICs peaked in 2007 – on the eve of the global financial and economic crisis – when China's GDP rose by more than 14 per cent, India's by more than 10 per cent, Russia's by 8.5 per cent and Brazil's by more than 6 per cent. At that point, the BRICs actually accounted for a full 2/3 of global economic growth. However, since then there has been a significant deceleration. By 2012, the BRICs' share of global GDP growth had fallen to less than half. In 2013-2014, the International Monetary Fund (IMF)'s current forecast indicates

FASTEST GROWTH IN CHINA SINCE 2000



GDP growth has been consistently higher in China than in the other BRIC countries since 2000, and the downturn there following the economic and financial crisis was very modest. There is also a good likelihood that China will continue to grow the fastest in this group of EM countries.

that average growth will be very modest from a historical perspective: 7.5 per cent in China, 4.5 per cent in India, 2.5 per cent in Brazil and 2.2 per cent in Russia.

What are the factors behind this deterioration in the BRIC growth dynamic?

By all indications, structural problems that have arisen over the past few years explain the growth deceleration in all the BRIC countries. First, the demographic trend – an increasing percentage of the population being of working age – which benefited the expansion of these economies for a long time has now reversed in Russia and China, where the available labour force is now shrinking. That will also be the case in Brazil within a few years, whereas in India, the labour force will continue to grow for another couple of decades. Second, the various growth strategies in the BRIC economies all seem to have lost their energy at the same time.

Brazil's economic success was based on market reforms launched by President Fernando Henrique Cardoso as well as on calls for greater fiscal discipline and the central bank's increased focus on inflation. These policies were continued by his successor, Luiz Inácio Lula da Silva, who took office in 2003. The Brazilian economy also benefited significantly from high commodity prices at the time. However, the pace of reforms eased after a while, with growth being driven increasingly by expansionary fiscal policy and increased bank lending to consumers and to a lesser extent by capital spending and exports. Brazil today is wrestling with major macroeconomic imbalances in the form of high inflation, poor competitiveness and far too little saving and investment.

Russia is still characterised by strong dependence on oil, which was highly beneficial to its economy 5-10 years ago but in today's world of more stable (possibly lower) oil prices risks being more of an Achilles' heel. The business climate in other economic sectors is bad, with high capacity utilisation and consequent inflation pressure. There is thus an acute need for structural reforms, but it is doubtful that such reforms can be launched before the growth trend decelerates and government finances move from surpluses to long-lasting deficits.

Like other EM countries, India benefited from the export boom early in the millennium, but a number of structural problems are now clearly making themselves felt. They include overregulation of the labour market and many product markets, fiscal programmes aimed not at capital spending and infrastructure but at household-friendly subsidies and tax cuts with an eye to winning votes, and an inability to curb inflation, with abrupt shifts in monetary policy as a result.

In China, after an exciting economic boom lasting more than a decade, the current shift in strategy from capital spending and exports in favour of private consumption has meant a deceleration in growth. Other challenges now facing the Chinese authorities are elevated debt levels in some parts of the economy, the risk of speculative housing bubbles bursting, and a reverse in the demographic trend. However, these challenges as well as many others are being addressed in the decisions made at the Third Plenary Session of the Communist Party Central Committee, held in November 2013. Included among the 60 detailed points that were announced are an easing of the country's one-child policy, a strengthening of the role of market forces in allocating resources and continued financial reforms.

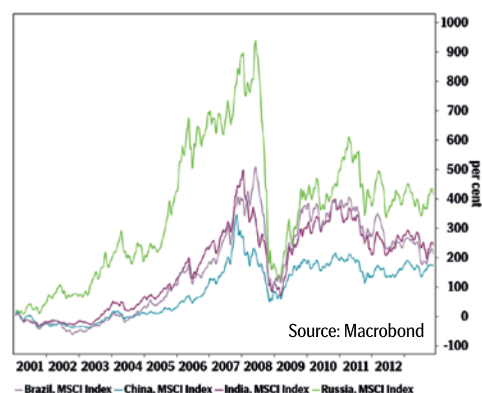
Although structural factors have caused all the BRIC economies to slow down, socioeconomic conditions today thus look very different in each country. This impression is reinforced by our macroeconomic model, which is based on comparisons of growth, inflation, government finances and trade balances in those economies in 2013-2014 as well as current economic momentum and macroeconomic risks/opportunities. The model ranks China well ahead of Russia, while Brazil and India are at the bottom.

So based on macroeconomic factor, is it perhaps time to switch from BRIC to C, that is, China?
What does a comparison of stock markets show?

The stock markets in all four BRIC countries turned in very strong performances between 2001 and the summer of 2008, before going into free fall in the autumn of 2008 after the Lehman Brothers collapse. Share prices rose in tandem from 2001 to 2008, except for the Russian market, which surged far ahead of the others but then plummeted during the financial crisis. After the crash, the Russian stock market recovered some of its lost ground, reaching a new high in 2011, although it has fallen in value since then. The Brazilian and Indian stock markets did well in 2009 and 2010, while the Chinese stock market lagged behind.

From 2001 to today, the Russian stock market – despite high volatility – has generated the best return, up just over 500 per cent in USD terms. The Indian and Brazilian stock markets come in second and third while China trails the field, up 250 per cent in USD terms. This year, the BRIC stock markets have had a tough time. Brazil has fared the worst, losing close to 27 per cent calculated in USD.

STOCK MARKETS STARTING TO MOVE IN DIFFERENT DIRECTIONS



The stock markets in the BRIC countries rose in similar fashion and performed very well during the period 2001 to 2008. The Russian market was by far the best performer but fell like a rock at the height of the financial crisis in the autumn of 2008. After two relatively strong years, 2009 and 2010, the BRIC stock markets have had a tough time, and share price curves are no longer moving in tandem, as they did at the beginning of the 2000s.

The stock markets in India, Russia and China have also been in the red, in USD terms, for most of 2013 (China has recently turned positive).

The BRIC countries have all expanded their share of the MSCI Emerging Markets Index during the period 2003 to 2013. India has shown the smallest increase, while China accounts for the biggest, growing from 7 to 19 per cent. The four stock markets have increased their total weight in the MSCI EM Index since 2003 from 25 to 43 per cent. In the global index (MSCI AC), their weight was 1.2 per cent in 2003, compared to 4.8 per cent today.

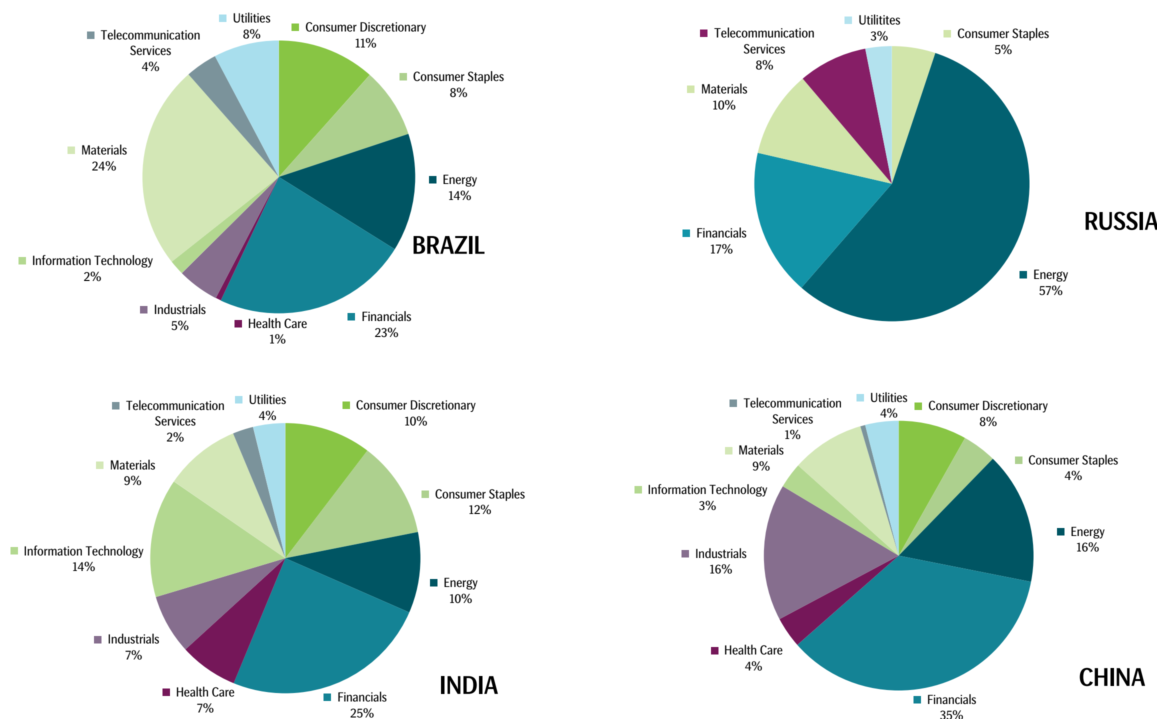
In valuation terms, the Russian stock market appears to be priced the lowest, with a P/E ratio for 2014 of 5.4. However, Russia has always had low valuations because of the large role played by listed commodity companies, which usually trade at low multiples. Our earnings growth forecast for Russia is negative for 2013 and 2014, which also explains the low valuations. In other words, investors have low expectations for Russian companies. Russian companies also rank at the bottom, along with Brazilian companies, in return on equity (ROE).

The Indian stock market is the most expensive of the BRICs today, with a P/E ratio of 13.5 for 2014. However, corporate earnings growth in the country looks attractive; Indian companies also deliver the best ROE at just over 17 per cent. Brazil's P/E ratio is 10.9 for 2014, with decent earnings growth expected for this year and next. Chinese listed companies are trading at a P/E ratio of 8.5, with stable earnings growth of 10 per cent, which should be considered attractive, and their ROE is 15.5 per cent, ranked second behind India. Overall, the valuations for BRIC stock markets – a P/E ratio of 13.7 for 2014 – are lower than valuations measured by the overall global index.

Earnings revisions are interesting because they indicate the direction of trends. Such revisions are currently slightly positive in China, while a negative trend applies to Brazil and India, and Russian estimates have fallen recently. Earnings revisions combined with low valuations and good underlying growth bode well for Chinese companies.

Conclusion: Thus, from BRIC to C

FINANCIALS HAVE INCREASING WEIGHT IN BRIC STOCK MARKETS, EXCEPT RUSSIA



The composition of BRIC equities indices at the sector level has changed a bit since 2001. In Brazil, consumer-related sectors, financials and commodities have increased their share, while telecom operators have decreased sharply in weight. In the Indian and Shanghai stock markets, financials have also grown in importance and now dominate. Energy, oil and commodities account for two thirds of the Russian stock market index, in itself a potential problem.

New values in a new world

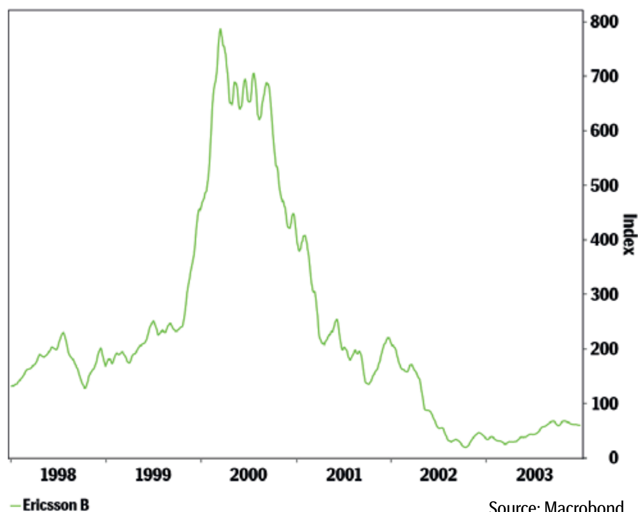
In recent years we have experienced a revolution, without really having reflected about what has actually happened. A new family of IT-related companies is emerging, and in an era when smart mobile telephones are in the hands of everyone, new technical opportunities have shaped new consumption patterns and thus new business ideas.

Let us begin this review by rewinding the tape.

March 6, 2000. Stock exchanges around the world have surged, especially America's technology-heavy Nasdaq. The Swedish stock market, which for many years has followed the broad American one, has shifted to more closely following the performance of Nasdaq. Everything related to information technology (IT) in a broad sense is surging. Telecom companies like Ericsson and Nokia reach new share price records, like many IT-related companies. The market capitalisation of such Swedish IT consulting firms as Framfab and Icon Medialab grow day by day. Asset managers, worried as they see valuations reach astronomical heights, are more or less forced to try to keep up with the rally.

At its peak, Ericsson's share of Swedish stock market capitalisation was nearly 50 per cent. There were many initial public offerings, and "everyone" wanted to have an "IT strategy" in their companies. "Everyone" was going to launch e-commerce. Those of us who were in Sweden remember the Boo.com fiasco – a bubble that burst even before it had time to inflate. So in March 2000, more and more people began questioning share valuations. The market began to sober up. The share price correction began with great force. We will let Ericsson serve as an example of this: From year-end 1998, its share price rose from SEK 174 to SEK 826, that is, by 374 per cent. From there, the share price fell by 98 per cent at the worst. In the autumn of 2003 the company carried out a new share issue at SEK 3 per share.

What we saw during this period was a classic example of a financial bubble. But what has happened since then? A new family of IT-related companies is emerging. Their common denominator is that the Internet, computers, laptops, e-readers and especially smart mobile telephones have opened new logistic platforms and opportunities. Consumption patterns have been reshaped, and business concepts have come and gone in response to new technical opportunities. A number of phenomena can be observed, and with them a number of young, extremely successful companies, whose real veterans



Source: Macrobond

WHEN THE MARKET WOKE UP, THE CRASH CAME

The chart shows the share price performance of by far the biggest share at that time, Ericsson (which accounted for nearly 50 per cent of market capitalisation on what is now the Nasdaq OMX Stockholm) between 1998 and 2003, when it carried out a new share issue. The company's share price movements were in no way unique among IT and telecom companies during this period.

are 15-20 years old and many no more than 2-3 years old. The ITustrial revolution is moving fast.

Phenomenon 1 – commerce

E-commerce (online retailing) is one part of the IT era that has lived on. Some e-commerce companies have experienced a more fundamentally driven renaissance. We have also seen closely related business concepts such as online auction sites thrive. Both these economic sectors go far back in time. Most of us remember traditional mail-order catalogues.

US-based Amazon is one of the world's largest e-commerce companies. Founded in 1994, it has expanded its business since then from books to include other product categories, such as home electronics, toys and games. In Sweden, companies such as Adlibris, CDON, Dustin, Netonnet and Zalando have been founded. And then all those package tour operators, which make a very high percentage of their sales on the Net nowadays. In addition, every self-respecting chain store has an e-commerce business.

Online auction firms are another type of commerce that is gaining ground. These firms have changed both our consumption and buying habits. We recycle, buy and sell used stuff like never before. EBay was founded in 1995 and operates in more than 30 countries today.

Blocket, founded in 1996, dominates the Swedish online auction market. Today the Blocket concept is found in 40 countries. The total value of goods advertised in 2012 was SEK 313 billion, equivalent to 9 per cent of Swedish GDP.

E-commerce has grown rapidly. In ten years, sales have multiplied seven times. Use by young people is also increasing, which indicates that the phenomenon is here to stay. Conceptually, it is also totally in tune with the times, with an emphasis on more recycling and less of a throwaway culture.

Phenomenon 2 – information and communication

In order to keep track of everything happening on the Net and find our way through the information jungle, we have the phenomenon of search engine companies. Google is the brightest shining star and has become so self-evident that it is now a verb – every month we "google" 12.7 billion times. At age 15, the company is a veteran in its business, but a youngster compared to many other companies of the same size.

Phenomenon 3 – games and music

The computer game business has made huge advances in recent years. It originally took off when home computers gained a foothold in the 1980s, but a lot has happened since then. Ten years ago, physical game consoles dominated the sector and had to be manufactured and distributed. With mobile platforms that download games in the form of an "app", business models have changed radically. Small companies can quickly and easily reach the world market, as two successful Nordic companies – Finnish-based Rovio and Swedish-based Mojang – have proven.

Rovio was founded in 2003. In 2009 it launched the game Angry Birds. Since then Angry Bird games have been downloaded a billion times. The company's sales grew to EUR 152 million in 2012, which was a 101 per cent increase from 2011. Earnings were EUR 55.5 million, an increase of 64 per cent from the year before. Revenue from consumer products (sweets, mobile phone cases, plush toy animals and more) tripled, and in 2012 accounted for 45 per cent of Rovio's total revenue. Mojang started in 2009, when it also launched a beta version of its Minecraft game (the full version was released in 2011). In 2012 the company reported sales of more than SEK 1.5 billion. Sales and earnings continue to increase at a rapid pace; these figures are for a firm that launched its main product only two years ago. This type of company has low costs and enjoys enormous margins on high volume, contributing to very good profitability.

The music industry is another sector that has changed dramatically, with large contributions from the Internet. Companies like Swedish-based Spotify and US-based Pandora have conquered the music world. Because of technical advances, small companies and new musicians can quickly reach the market. Large, expensive logistics are no longer needed for launches.

Phenomenon 4 – social media

Last but not least, social media – definitely a revolution in the way we communicate and how information spreads. Facebook was founded in 2004 and in only a few years has conquered social media. Today there are 1.2 billion users; if it were a country, it would be the world's second-largest after China. Facebook has obviously revolutionised both our everyday life and our ability to communicate and maintain contact across national boundaries.

Instagram is the veteran among social networks for photos and was launched in 2010. As early as 2012, Facebook snapped up the company, which shows the importance of connecting different types of networks and how vital it is from a revenue perspective to follow users. The battle for advertising revenue is won by being wherever consumers are in the digital world.

The microblog service Twitter is another type of network and has about 232 million users today. It, too, has become a verb. Today many politicians, opinion moulders and musical and cultural celebrities often "tweet" messages. Global tweeters include US President Barack Obama.

LinkedIn has specialised in professional networking and has about 260 million users today.

All these companies have in common that their growth has accelerated in recent years, driven among other things by continued technological advances in mobile applications. Because mobile devices are always accessible, frequency of use has also greatly increased.

The investor perspective

Many new companies have emerged in a very short period and have become global enterprises. Some are publicly traded and others are not. Some are making money and others are not. Since its initial public offering in 2012, Facebook's share price has been on a roller-coaster ride, but after a downturn during its IPO year the price has nearly doubled in 2013. Twitter's IPO took place in November this year and its share price has already

surged more than 50 per cent, even though many observers thought the introductory price was set high. This type of company is obviously attractive to many investors.

As investors, how should we view this? In some cases, valuations are reminiscent of the IT (or dotcom) boom at the turn of the millennium, mainly because many companies are not yet earning money.

The revenue model for many of these companies – for Google as well as social media companies – is based primarily on advertising revenue. This is also the big dilemma for companies. They face a delicate balancing act between user-friendliness and the quantity of advertising they carry.

According to the *Financial Times*, the global advertising market is worth some USD 500 billion, of which the largest social networks account for about USD 7 billion. This is what optimists cite in their analyses. They see major revenue potential ahead, since this market share is expected to increase. A larger slice of the advertising pie is definitely one way that social networks can grow, but this is also its limitation and is one reason why these companies are constantly looking for new customers/users and like to make acquisitions.

The landscape is fast-changing, and for every winner there is often a loser. As an investor, it is equally important to see both sides of the coin. Take e-commerce as an example: The winners may of course be the most successful e-commerce companies, but this is a business with narrow margins, so analysing it is not so easy. Perhaps the actual winners are those traditional retailers who succeed in capitalising on both traditional commerce and e-commerce, or perhaps the transport and logistics companies that handle the rapidly growing number of packages that must be shipped around the world. In our opinion, it is thus necessary to view these phenomena in a broader perspective and adopt a thematic approach, rather than looking directly at specific companies.

One clear pattern among these new IT businesses is consolidation, which creates opportunities not only for the founders/owners of these companies, but also for investors who are able to identify buyout targets at an early stage. Yet investing in a company solely because you believe it is a buyout candidate is rarely a sufficient analysis for achieving successful returns.

Regardless of how we as investors view putting our money into these particular technology companies and sectors, it is very beneficial to stock markets around the world that new companies are joining them. For many years, the trend has instead been that private equity firms have been draining stock exchanges of well-managed companies. And even innovative companies that never reach the stock market help indirectly to drive technological development and entrepreneurship in these fields to new heights. Capital is being made available for creative business founders, who in turn tend to continue investing in new ideas.

An ITustrial revolution?

Some people thought the Internet was a fad and that everything had already been invented twenty years ago, but technological development continues at a rapid pace and we can be quite sure that we have not seen everything yet...

The industrial revolution of the late 19th century went down in history as a wave of technological development that transformed the world. The digital world map has been re-drawn in just 15 years. And what we have seen in recent years is indeed also a revolution, an ITustrial revolution.

COMPANY	AMAZON	APPLE	EBAY	FACEBOOK	GOOGLE	LINKEDIN	TWITTER
Founded	1994	1977	1995	2004	1998	2003	2006
Year of IPO	1997	1980	1998	2012	2004	2011	2013
Share price change since IPO	+24,071%	+13,690%	+2,583%	+22%	+845%	+380%	+58%
Share price change, 3 years	+101%	+67%	+67%	-	+72%	-	-
Market capitalisation, Nov 2013 (USD million)	165,960	463,365	65,234	115,696	341,540	25,814	23,277

Source: Company reports, Bloomberg

Markets and asset classes

Macro summary

An increasingly vigorous world economy

- *Looking ahead, the global economy has good potential to grow faster*
- *The chances of an unexpectedly strong expansion depend mainly on the US, but economic policy events may lead to a worse scenario than our forecast*
- *Growth will accelerate in developed markets, while emerging markets will not achieve their earlier growth rates*

We foresee good conditions, especially low inflation, for higher global growth over the next couple of years – with the United States leading the way. Other parts of the world economy have varying potential to benefit from the US upturn, both among OECD industrialised countries (developed markets, or the DM sphere) and emerging markets (the EM sphere). Looking ahead, cyclical differences will thus persist. Due to structural and other problems, the EM sphere will not achieve the growth rates that prevailed earlier.

The chances of faster global growth than in our main scenario will depend on whether the US economy will be stronger than expected (20 per cent probability). A weaker global performance than expected (25 per cent) will most likely be due to economic policy events, with new fiscal policy deadlocks in the US as the biggest risk.

US growth will surge

We believe that the effects of October's budget conflict on US growth will be minor and temporary. There are reasons to be optimistic about the economy as 2014 approaches. These include a better labour market, strong household balance sheets, larger corporate capital spending needs and diminished fiscal headwinds. The political picture also includes a January 15 deadline for a new federal budget agreement and a deadline late in the first quarter for raising the federal debt ceiling. Political discord will probably be less than it was this autumn. We expect American GDP to grow by more than 1.5 per cent this year and by around 3.5 per cent in 2014 and 2015. Because of persistently low inflation and some short-term uncertainty about the economy and fiscal policy, the Federal Reserve (Fed) will probably hold off on reducing ("tapering") its stimulative monthly bond purchases until March 2014. We predict that the Fed will leave its key interest rate unchanged at 0.25 per cent until the fourth quarter of 2015.

Debts and joblessness weigh down euro zone

The euro zone economy is growing again but remains weighed down by a large debt burden and high unemployment. Several crisis-hit euro zone countries – mainly Greece and Portugal – are likely to need a softening of borrowing terms, and possibly also further bail-outs. The European Central Bank (ECB) will also have to keep propping up the financial system as well as stimulating the economy and working to stave off deflation. Meanwhile euro zone exporters will benefit from the economic upturn in the world generally and the US specifically, while fiscal austerity measures in crisis-hit countries will be less far-reaching. We predict that euro zone GDP will shrink by 0.4 per cent this year and grow by less than 1 per cent in 2014. Low inflation and worries about the economy were factors that helped persuade the ECB to cut its refi rate to 0.25 per cent in early November. By all indications, the next step from the ECB will be to supply more liquidity to banks in the form of new Long Term Refinancing Operation (LTRO) loans.

British economic strength

Third quarter GDP growth in the United Kingdom was the highest in more than three years. The manufacturing and service sectors, as well as construction and agriculture, expanded. We expect GDP growth of less than 1.5 per cent this year, and 2.5 per cent in 2014. Despite plenty of idle production resources, inflation has remained above the Bank of England (BoE) target of 2 per cent and is likely to take time before falling below target. The BoE is thus in no hurry to tighten monetary policy. We expect the bank's key interest rate to remain at 0.50 per cent until the end of 2015.

No uniform trend in the Nordic countries

Nordic economic performance remains a bit divergent. In Sweden, growth was marginal during the second quarter of 2013, but recent macroeconomic data are raising hopes of acceleration. In the Norwegian economy, there was a significant loss of momentum in the first half, but better growth during 2014 is likely in Norway too. The Danish economy has experienced stronger growth in the past six months, and there

is a good chance that this trend will persist. Finland, however, is struggling with both cyclical and structural problems. The upturn that nevertheless appears to be on its way will be conspicuously weak. Overall Nordic GDP will increase by 0.5 per cent this year and by around 2.5 per cent both in 2014 and 2015.

Clear impact from Abenomics

Japan's new economic policy – Abenomics – has had a clear positive effect. We predict GDP growth of nearly 2 per cent this year and around 1.5 per cent both in 2014 and 2015. The consumption tax hike next April and the Bank of Japan's unprecedentedly loose monetary policy will boost inflation, giving the country a chance to end its deflationary spiral. If Abenomics falls short due to insufficient structural reforms, major government financial problems are lurking around the corner, as exemplified by gross debt totalling nearly 240 per cent of GDP. An ageing population with rising health care expenses will also challenge government finances.

Asian emerging economies poised for rebound

Last spring's signals from the Fed about a coming reduction in monetary stimulus had a major impact on many financial markets in Asia. Although these worries affected China only to a minor extent, India and Indonesia were harder hit due to major economic imbalances and structural problems. Financial market turmoil has now faded and the region has begun to grow a bit faster again, helped by higher demand both in international and domestic markets – the latter thanks to better labour markets, orderly government finances and low inflation pressure, allowing continued expansionary monetary policies in many countries. We predict a regional GDP increase of around 6 per cent during 2013 and 2014, and a little higher in 2015.

In the third quarter, Chinese growth accelerated to 7.8 per cent, but there are signs that infrastructure investments are beginning to slow. We forecast a GDP increase of around 7.5 per cent this year and next, and 7 per cent in 2015. Despite large remaining imbalances and high inflation, the Indian economy should be able to gain momentum in the near future. GDP will grow by more than 4.5 per cent in 2013, about 5 per cent next year and 5.5 per cent in 2015.

Latin America facing headwinds

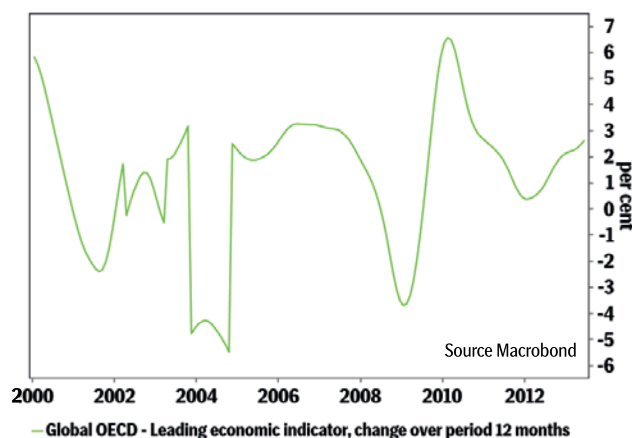
Latin America has experienced headwinds from several directions during 2013. The Fed's signals last spring of less monetary stimulus had an especially large impact on Brazil's financial markets. The falling Brazilian real helped boost inflation, which in turn led to a series of key interest rate hikes. Meanwhile low or falling commodity prices have pulled down the economies of many countries in the region. One country that is performing better in various respects is Mexico. We forecast that overall Latin American GDP will grow by 3 per cent this year and 3-3.5 per cent in 2014 and 2015, while the rate of price increases gradually fades.

Divergent economic outlook in Eastern Europe

Most economies in Eastern (including Central) Europe have begun to recover since last summer. Leading the way is Central Europe, helped by higher German demand and rising private consumption. The purchasing managers' indices for manufacturing in Poland and the Czech Republic have climbed noticeably. By all indications, the Polish economy is poised for a significant acceleration in activity. Even in hard-pressed countries to the south such as Bulgaria and Croatia, the growth outlook has brightened a bit, but Russia has diverged in a negative direction. So far this year, the Russian economy has decelerated sharply on a broad front; looking ahead, there will be a modest upturn. Price pressure in Eastern Europe is being held in check by large idle capacity (except in Russia), along with low or falling commodity prices. Latvia and Lithuania will remain the fastest-growing EU countries, largely due to expanding private consumption, but growth in the smallest Baltic economy, Estonia, is lagging. A recovery there will depend on an upswing in international demand, especially from Finland and Sweden. Inflation in Latvia and Lithuania, now nonexistent, will be modestly higher in the near future. But Lithuania, as the last Baltic country, is likely to qualify for euro zone membership starting in 2015. Last summer, Latvia got the green light to join the euro zone in 2014.

An increasingly vigorous world economy

The global economy is becoming more and more vigorous. We predict that world GDP will increase by more than 3 per cent this year, 4 per cent in 2014 and more than 4 per cent in 2015. Although the EM countries will be the fastest-growing – nearly 5.5 per cent a year in 2014-2015 – the difference between the EM and DM spheres will narrow significantly. This is because developed market GDP will grow by an estimated 2.5 per cent in 2014 and nearly 3 per cent in 2015, after slightly exceeding 1 per cent this year.



SENTIMENT INDICATORS POINT TO RISING ECONOMIC GROWTH

Leading indicators foresee a continued upward trend in DM economies. The US is leading the upturn. The UK and smaller developed economies are also showing good strength. The euro zone economy will recover too, but slowly. Japan's economy will keep growing, though at a gentler pace.

Expensive, but finally normal

- Share prices up 50 per cent, earnings down 15 per cent
- Low return requirements, normal relative valuations
- A lost year for companies, but 2014 will be better

In the past two years, the Nasdaq OMX Stockholm exchange has gained 50 per cent, but the entire upturn and more can be explained by higher valuations, since the earnings of listed companies decreased by about 15 per cent between 2011 and 2013. Today investors are valuing each krona in earnings that companies generate at the highest level in 10 years, if we disregard 2009, when earnings generation was extraordinarily depressed. This means that the earnings yield (earnings as a percentage of market capitalisation) of 6.1 per cent is unusually low.

Highest valuations since 2007

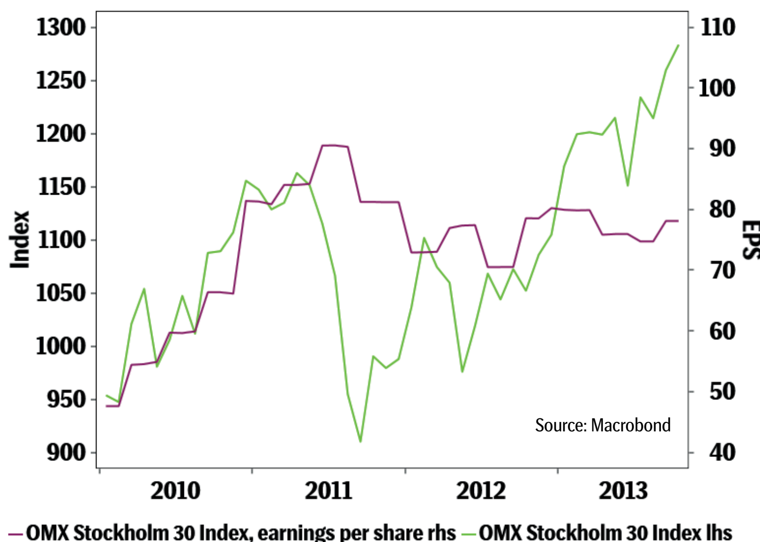
The price to book ratio in listed companies can often provide a different picture of valuation than earnings-related financial ratios. The price to book ratio in 2006 was an indication that company earnings expectations were at their highest level since the IT (or dotcom) bubble was punctured, despite high earnings yield. But those who looked at the same financial ratio in 2009 clearly saw that expectations for future company earning power were very low at that time, even though earnings yield was low (price/earnings ratio was high).

This time around the picture is unfortunately the same, regardless of the yardstick used. Earnings yield is low, while company equity recently equalled its highest valuation since 2007.

Expectations proved incorrect

Although it was obvious a year ago that companies would show weak earnings in the first quarter of 2013, after that we expected a steady improvement during the year. Unfortunately, reality has not lived up to our

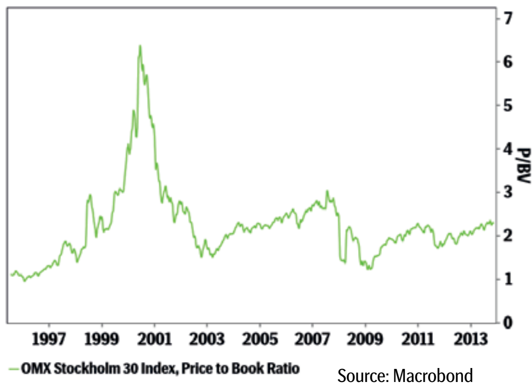
STRONG SHARE PRICE RALLY, WEAK EARNINGS TREND



The chart shows the performance of the OMXS30 Index in Stockholm and the earnings trend of the same 30 companies on a rolling historic 12-month basis since 2010. Over the past two years, share prices have climbed by about 50 per cent while earnings have decreased by about 15 per cent.

expectations. At that time, we foresaw positive earnings growth in 2013, but it instead
appears to be the second year in a row of falling earnings. So far this year, we have been forced to adjust our earnings forecasts for 2013 downward by nearly 15 per cent and our forecasts for 2014 by 13 per cent.

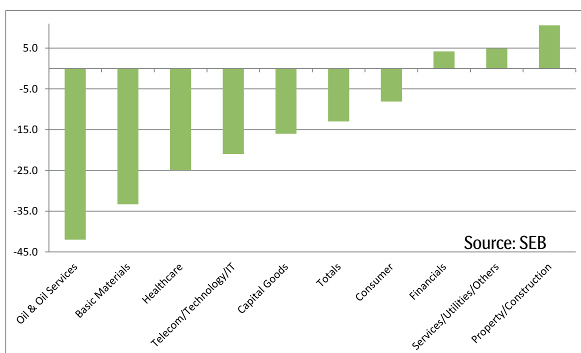
EQUITY VALUATIONS HAVE CLIMBED SHARPLY



The chart shows book value of equity for companies listed on the Nasdaq OMX Stockholm exchange, according to the OMXS30 Index since 1995. After four years of a strongly upward trend, valuations have again reached relatively high levels but are still far below their old peaks.

The breakdown by sector shows performance is far from uniform, however. Primarily cyclical sectors have accounted for the big disappointments during 2013, which have resulted in substantial reductions in forecasts. On the positive side, financials, construction and real estate and the service sector stand out. Yet it is difficult to foresee large earnings improvements from current levels for the stock exchange as a whole, or a reversal of the trend towards downward revisions of earnings forecasts, unless the industrial sector takes off. Happily, an improvement for manufacturing firms should be near. We expect a 12 per cent earnings upturn in 2014 for Swedish listed companies (17 per cent for Nordic ones).

EARNINGS FORECASTS HAVE BEEN ADJUSTED DOWNWARD

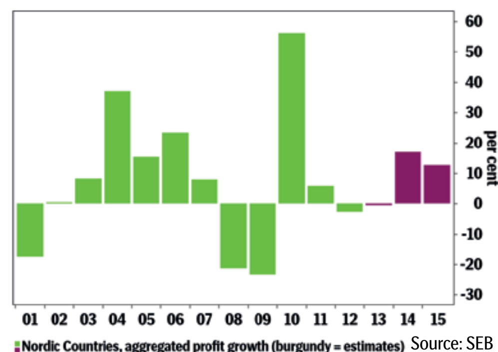


The chart shows our earnings forecast adjustments by sector so far this year, referring to 2014 earnings. Analysts have been forced to adjust their forecasts downward several times, especially for industrials and commodities, and an accelerated downturn was discernible after company reports for the third quarter of 2013.

Hopes for a better 2014

Historically, purchasing managers' indices have been good leading economic indicators. Although it is difficult to reconcile last summer's cheerful sentiment among purchasing managers with the third quarter reports recently published by listed companies, it is unreasonable for the economic picture to remain as divided as it is today over a long period. Ordinarily, good and rising economic momentum in purchasing managers' indices should also be visible in the order bookings of manufacturing companies. By now, analysts' expectations of an imminent positive turnaround in cyclical industries are beginning to look like the story of Peter and the Wolf. An imminent positive turnaround has been postponed repeatedly, and in some cases investors have given up hope. Cyclical companies dominate the list of this year's stock market losers. Are they about to get their revenge in 2014?

EARNINGS WILL CLIMB AGAIN



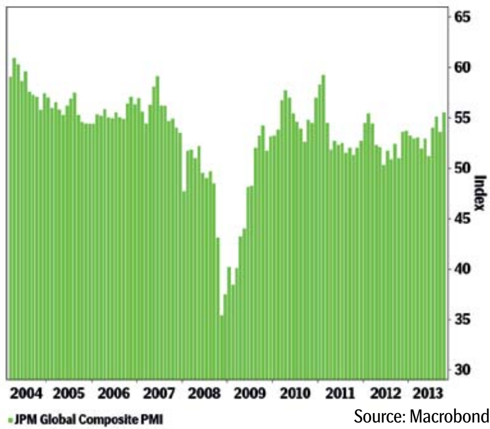
The chart shows historical earnings growth for Nordic listed companies, plus our forecasts for 2013, 2014 and 2015 in per cent. Our expectations for 2013, published a year ago, proved far from correct. But is it time for an upturn in 2014 instead?

Upside-down approach to risk

Although strong stock market performance in recent years has resulted in higher valuations, it is ironic that many investors perceive that the risks associated with putting their money into equities have decreased rather than increased as a consequence. Even those who entered the Swedish stock market (as measured by the OMXS Index) at the worst possible time, when prices hit record highs during the summer of 2007, have earned about 25 per cent until today thanks to dividends. This is admittedly somewhat worse than what a portfolio of Swedish government bonds would have earned them during the same period, but it is better than can reasonably be expected from such a portfolio over the coming seven years. As a result of the upturn, the old classic view that equities are the best investment over time has been dusted off and has begun to influence investor behaviour once again.

The prevailing way of measuring financial market risk is volatility, that is, price fluctuations. This is advocated both by Nobel laureates and by the authorities that oversee financial market institutions. Volatility was historically high during a long period from 2008 to 2011 but has decreased dramatically since then.

FAR STRONGER OPTIMISM



The chart shows a weighted index of global purchasing managers' indices from both the manufacturing and service sectors, compiled by JPMorgan. The index is thus a good leading indicator for the global economy. In recent months, it has climbed to 55.5, which is compatible with good growth and is the highest level since February 2011. Will this optimism be confirmed in future quarterly reports?

It is worth noting that one of the world's most successful equities investors, Warren Buffett, is critical of volatility as a measure of risk and instead advocates safety margins when assessing the value of assets (the lower the value, the greater the safety margin in case something goes wrong, and thus the lower the risk). Based on Buffett's reasoning, the risk of equity investments has increased greatly in recent years, but since so many investors instead focus on historical returns and volatility, the risk of equity investments is instead being perceived as significantly lower.

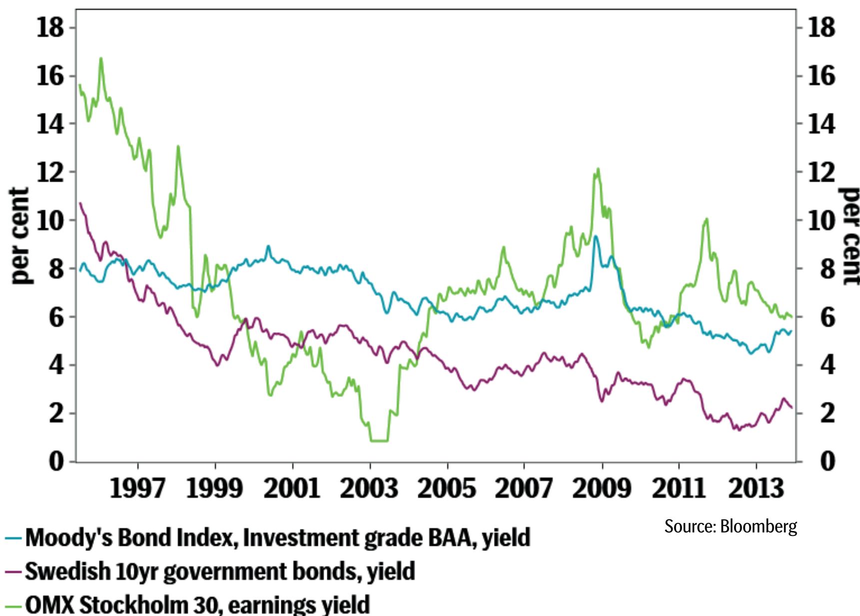
Valuation bubble or normalisation?

Swedish and Nordic stock market performance is not internationally unique. Compared to world indices, the increase in valuations of company earnings and the price to book ratio has instead been modest.

Nor are stock market valuations extremely high compared to other assets. While valuations are beginning to look strained in absolute terms – in other words, earnings yield is historically low – relative valuations are actually normal. But note that it is difficult to define "normal", when stock market history includes both the euphoric period at the turn of the millennium and the Lehman Brothers crash, when the situation was the opposite. If we look at a chart of earnings yield on the Nasdaq OMX Stockholm exchange compared to two typical investment alternatives – yields on Swedish long-term government bonds and yields on US long-term investment grade corporate bonds – it turns out that the return requirements on all three are relatively low, but the mutual relationship among them is not remarkable. The risk premium on equities today is close to its median value for the past 18 years.

Low interest rates and yields also drive capital flows into the stock market, even though valuations do not look attractive. Investors are forced to choose between equities with high valuations and other investment alternatives with even higher valuations. During the past year, when the corporate earnings trend has not been impressive, the stock market's trump card has been that equities appear to be the least bad alternative.

RETURN REQUIREMENTS HAVE FALLEN FOR BOTH EQUITIES AND BONDS



The chart shows earnings yield (inverted price/equity ratio, in per cent) on the Nasdaq OMX Stockholm exchange, compared to yields on 10-year Swedish government bonds and on long-term US corporate bonds of relatively good quality (BAA). Return requirements for all three types of assets have undergone a dramatic downward adjustment over the past 15 years.

Expectations and suitable strategy

There are bubble tendencies in portions of the stock market today. Expectations are very high in some cases, but this is not true of the market as a whole in light of low interest rates and yields. If our forecasts of double-digit percentage earnings growth in 2014 and 2015 prove correct, earnings will catch up with today's valuations relatively soon, even in absolute terms, and in the meantime investors can earn yearly dividends of 3.7-4.0 per cent.

In a scenario of flat share price performance, where dividends account for most of total return – which we find reasonable – we believe that investors will identify three paths towards generating better returns: First, the search for high dividends will probably continue. Second, the choice of individual equities will become even more important; among other things, this means that the heavy interest in small-cap shares will probably continue.

And finally, it will also mean that those who manage to take advantage of short-term fluctuations correctly can outperform the stock market, but investors as a group will – by definition – not be successful.

Summary

Stock market valuations have risen greatly in recent years. This means that expectations are high and the risk of disappointments is higher. Yet in contrast, good share price performance combined with lower volatility means that many people instead perceive risk as being lower than before. Equities nevertheless seem to be the least bad alternative for many people today. Although 2013 has been a real disappointment in terms of the earnings performance of cyclical companies, purchasing managers' indices are telling investors that these companies may soon get their revenge.

World stock markets still delivering

- **Substantial gains after Fed "tapering" is postponed**
  September and October saw share prices rise after the US Federal Reserve unexpectedly delayed implementation of its tapering, or phase-out, of bond purchases, until next year. 2013 looks set to be a good year for equities. So far, the world index is up about 20 per cent in local currencies.
- **Many factors bode well for investing in Europe**
  Corporate earnings are growing faster in Europe than in the US. Macroeconomic data and accommodative fiscal policy in Europe are also sending positive signals. Market-leading cyclical and consumer-related companies should benefit from a strengthening economy and a higher share of sales to Asia and other emerging markets.
- **We need to see higher earnings to sustain the rally**
  Global equities have long generated good returns, and valuations have risen. We are now in a situation where we need to see growth in the form of upward-adjusted earnings in order for share prices to rise.

JAPAN TOPS THE WORLD'S STOCK MARKETS

US, S&P 500 — Japan, Nikkei 1000 — China, Shanghai
Euro zone, STOXX — Brazil, Ibovespa

The Japanese stock market tops the global list this year. However, the Japanese yen has weakened, which means that the increase recalculated into other currencies is not as strong. US and European equities have also performed well. The stock markets in Brazil, Russia and parts of Asia have fared worst.

A POSITIVE MOOD HAS PREVAILED in the world's stock markets this autumn. In early September, the US Federal Reserve (Fed) surprised investors by announcing it would postpone its "tapering" until after the end of the year, which fuelled market rallies. Both September and October saw share price gains, and so far this year the world index has risen just over 20 per cent in local currencies. Emerging market (EM) shares have kept pace with the rally during the autumn, with Russia, India and Brazil at the forefront. Nevertheless, the sizeable gap between EM and developed market (DM) equities seen at the beginning of the year persists. Stock markets in Japan, the US and Europe have risen between 20 and 40 per cent in local currencies, whereas those in China, Hong Kong and Brazil have lost value. The EM stock market index has been dragged down mainly by Latin American countries.

Cyclical sectors and IT are undervalued

Defensive sectors have continued to perform better than sectors that are sensitive to business cycles worldwide. Share prices of pharmaceuticals and consumer discretionary companies have risen almost 30 per cent this year while those of commodities, which are strongly correlated with global growth, have fallen in value. Cyclical and consumer-related sectors have the highest expected growth for 2014 and are thus attractive investment alternatives. After their gains, shares for pharmaceutical and consumer discretionary companies have high valuations, with a P/E ratio of around 16. In contrast, information technology and other cyclical sectors have low valuations and are thus preferable to defensive sectors.

Focus on Europe

Corporate earnings are expected to grow 6 per cent in 2013 and 11 per cent in 2014, with a slightly better outlook for EM countries (8 per cent) this year. As a result, EM earnings have been adjusted downward this year, coming ever closer to DM levels. European earnings forecasts top the DM, with 14 per cent growth next year, while US corporate earnings are expected to increase by 10 per cent. That bodes well for investing in Europe rather than the US. The situation in Europe is gradually improving, bolstered by low valuations. Stabilising macroeconomic data and accommodative fiscal policies are also sending positive signals. Cyclical companies in Europe should benefit from the strengthening economy. Many market-leading exporters in Europe (for instance, Nestlé, LVMH and H&M) in the industrial, consumer and luxury good sectors have a large percentage of their sales in Asia, especially China.

Positive earnings adjustments in Japan

In Japan, earnings have been revised sharply upward. Japanese companies in consumer-related sectors and financial services are showing the biggest improvements. In the EM sphere, South Korea and Taiwan show the best earnings growth. Chinese corporate earnings are expected to rise 10 per cent this year and 9 per cent next year, whereas Russian corporate earnings will not grow at all.

The global stock market is trading at a P/E ratio of 16 for 2013 and 14 for 2014, which – it should be said – is in line with the historical trend although slightly on the high side. It is worth noting that Japanese shares, which have historically traded at multiples above 20, have now fallen to a more "normal" P/E ratio of 14.5 for next year as a result of positive earnings revisions. US shares are trading at a P/E ratio of 15 while those in Europe are lower (P/E ratio 13). All in all, the EM sphere is cheapest, with a P/E ratio of 10 for 2014. China and South Korea look particularly attractive from a valuation perspective.

Higher earnings are needed

World stock markets have generated good returns for a long time. Valuations have gradually risen during the year, since earnings have not kept pace with share price gains. The market trend is now positive and we are cautiously optimistic. Signs of global growth and accommodative central bank measures will probably provide further fuel to the market. However, we are in a situation where we need to see confirmation of growth, in the form of higher corporate earnings and upward earnings revisions to enable share prices to rise from this level.

REGION	WEIGHT*	REASONING
Globally	1 2 3 4 **5** 6 7	The trend is positive, but the markets have taken a hesitant approach since the corporate reporting period because of continuing downward earnings revisions. Share valuations have risen. We need confirmation of growth in the form of higher earnings. The risk factor now is the Fed's tapering pace.
Europe	1 2 3 4 **5** 6 7	The situation in Europe continues to improve. Valuations are low compared to the US and globally, and earnings growth is attractive. The European Central Bank (ECB) and fiscal policy are providing support, while macroeconomic data are stabilising.
US	1 2 **3** 4 5 6 7	Macro data have been relatively stable, which has already produced a strong market that is trading at record levels. Valuations are starting to become high, which limits the potential here.
Asia/EM	1 2 3 **4** 5 6 7	Asia continues to be a growth investment in the long term, but it is a mixed picture. Unstable macro forecasts mean that we are tactically reducing the weighting somewhat in our portfolios. Choose less developed countries in Asia with continued high growth potential. Avoid investments in pure commodity exporters.
Japan	1 2 3 **4** 5 6 7	The government's stimulus package has triggered a stock market rally and a sharp fall in the Japanese yen. The impact of this policy is now being seen in macro statistics. High earnings forecasts and upward-revised earnings, although from low levels. Stimulus measures are having a positive effect on Asia as a whole.

** "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.*

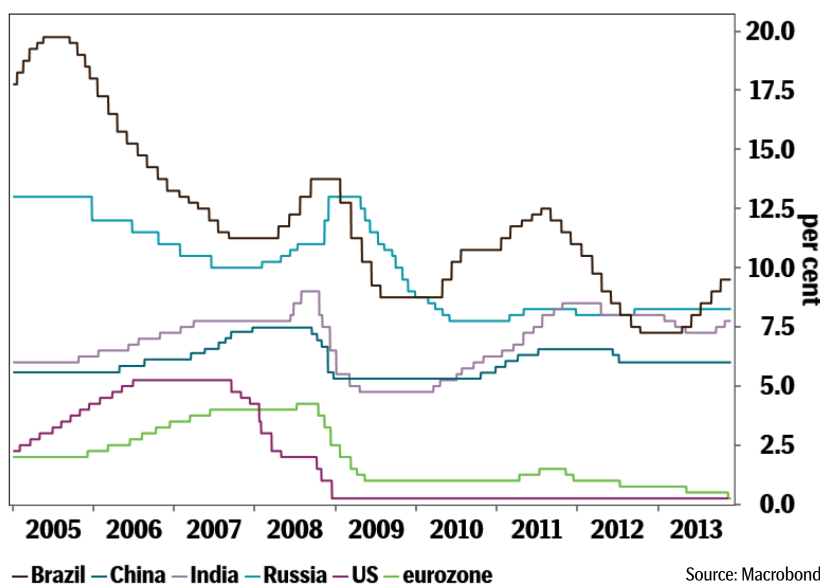
Different interest rate patterns worldwide

- **DM and EM monetary policies differ**
  While highly accommodative monetary policy – including historically low and stable benchmark interest rates – characterises most of the developed market (DM) sphere, there is considerable variation in the emerging market (EM) sphere. Some countries are raising their key rates, whereas others are lowering them.

- **Differences in inflation an important explanation**
  In DM countries, low inflation is setting the stage for low benchmark interest rates and only slowing rising government bond yields. In the EM sphere, there is a group of countries with high inflation and falling currency exchange rates, setting the stage for a hike in key interest rates and a rise in bond yields.

- **The search for yields favours high yield bonds**
  Historically low yields on government securities in DM countries means that fixed income investors looking for yields are setting their sights on the high yield (HY) market and emerging market (EM) debt. Considering the risk picture, we find HY much more attractive than EM debt.

HIGH BRIC KEY RATES, FAR LOWER ONES ON BOTH SIDES OF THE ATLANTIC



Source: Macrobond

In the BRIC countries there is pressure to raise key interest rates, especially due to high inflation. During 2013 the central banks in Brazil and India have hiked their rates repeatedly, and China is expected to follow suit in 2014. In the United States and Europe, however, key rates are very low, and the European Central Bank (ECB) carried out a further cut in early November. Meanwhile the US Federal Reserve is making large bond purchases, and the ECB may launch a similar quantitative easing programme next spring.

DESPITE THE STRENGTHENING ECONOMY in the industrialised OECD countries, monetary policy – a combination of conventional interest rate policy and unconventional asset purchases – has been accommodative to an unprecedented extent in almost all of these countries. However, in the emerging market (EM) sphere, monetary policies diverge considerably. In some countries, key interest rates are being lowered; in others, they are being raised. The causes of these divergent interest rate patterns can largely be found in different macroeconomic conditions.

In developed market (DM) countries, a trend towards decelerating inflation (disinflation) is increasingly apparent, even though the economic upswing has been under way for just over four years and there has been an ample dose of monetary stimulus in historical terms. There are a number of causes. Among the most important are substantial spare production capacity – which is keeping costs under control – stable commodity prices and a rather modest economic growth rate in the wake of repaired balance sheets and debt deleveraging by governments, companies and households.

The absence of inflation pressures – and in some places a risk of deflation (generally falling prices) – is giving DM central banks greater freedom as well as reason to pursue an expansionary policy. Low benchmark interest rates combined with bond purchases and low inflation, in turn, set the stage for only slowly rising government bond yields on both sides of the Atlantic.

On the other hand, a number of EM countries are showing symptoms of overheating in the form of rising inflation and growing current account deficits, combined this past summer with falling exchange rates. Inflation was thus further fuelled by more expensive imports. Examples of countries facing an overheated economy are India, Indonesia and Brazil. Interest rates have been raised in these countries in 2013 to reduce macroeconomic imbalances and stop the decline in their currencies. Examples of other EM countries that are experiencing far smaller socioeconomic imbalances and have not needed to resort to interest rate hikes are China, South Korea, Mexico and Poland. The Polish key interest rate has in fact been lowered on several occasions over the past year.

Taking a look in the rear-view mirror since year-end and looking into our crystal ball for 2014 – given the above – the movements in EM government bond yields have not been as uniform as in DM countries, which in itself implies a risk for fixed income investments in EM debt. Add to this the frequent occurrence of sizeable exchange rate swings for many EM currencies.

Thus, although there is reason at this time to be cautious about EM debt, government bonds in the DM countries are not attractive either. That is because market yields (running yields) are historically low, and by all indications we are facing rising government bond yields with subsequent price pressure on bonds. The return potential for government bonds in DM countries is anything but good.

As before, corporate bonds in the high yield (HY) segment still appear to be the most attractive type of asset in the fixed income world. And as before, the arguments in favour are good corporate health in terms of earnings/balance sheets and a low percentage of corporate bankruptcies, fixed income investors' search for yields, exceptionally accommodative monetary policy in the DM sphere, and a general economic climate going forward that should favour investor risk appetite. The yield gap between HY corporate bonds and government bonds has obviously narrowed significantly over the past several years, but running yields on HY bonds are still at attractive levels, and there appears to be little risk of a substantial rise in bond yields and thus a sizeable fall in HY bond prices.

ASSET CLASS	WEIGHT*	EXPECTED RETURN NEXT 12 MONTHS		RISK	
		SEK	EUR	SEK	EUR
Treasury bills	1 **2** 3 4 5 6 7	0.9%	0.1%	0.0%	0.1%
Government bonds	1 **2** 3 4 5 6 7	-0.6%	0.4%	4.4%	3.9%
Investment grade corporate bonds	1 2 **3** 4 5 6 7	1.6%	0.6%	3.0%	3.0%
High yield corporate bonds	1 2 3 4 **5** 6 7	5.9%	5.0%	3.8%	3.8%
Emerging market debt	1 2 **3** 4 5 6 7	7.0%	7.0%	10.4%	11.5%

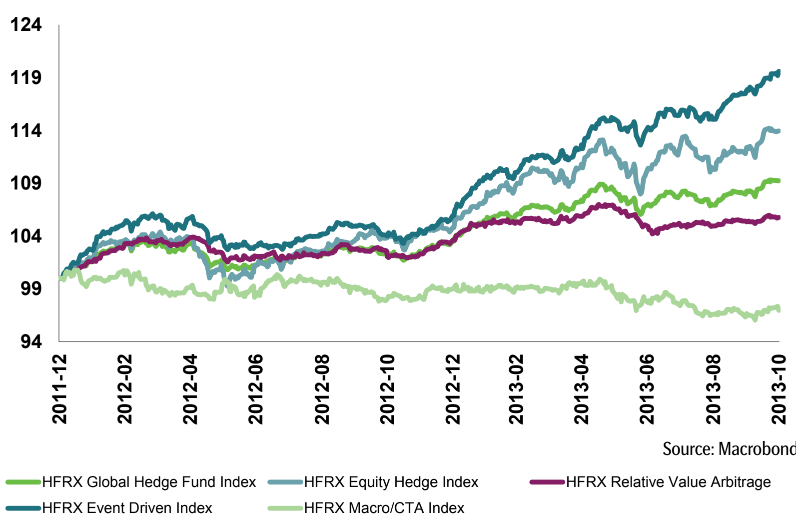
Source: SEB

** "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.*

Lower correlations benefiting various strategies

- The market climate for hedge funds has improved, with a lower correlation between different asset classes
- The desire of fund managers to diversify portfolios is generating large flows into hedge funds worldwide
- The economic situation is benefiting equity-based and event-driven strategies

INCREASED TRANSACTION ACTIVITY MAKES EVENT-DRIVEN STRATEGIES A WINNER THIS YEAR



Greater risk appetite in the market is an effect of lower correlations between asset classes and provides a good climate for many hedge fund strategies. So far this year, event-driven strategies have performed best, with gains of almost 13 per cent.

STRATEGY	INDEX	PERFORMANCE % (USD)				
		YTD (Oct 31, 2013)	H1 2013	2012	2011	2010
Global Hedge	HFRX Global Hedge Fund	5.5	3.2	3.5	-8.9	5.2
Equity Hedge	HFRX Equity Hedge	8.7	4.6	4.8	-19.1	8.9
Relative Value	HFRX Relative Value Arbitrage	2.1	1.4	3.6	-4.0	7.7
Event Driven	HFRX Event Driven	12.9	7.4	6.0	-4.9	2.0
Macro	HFRX Macro	-2.1	-1.1	-1.0	-4.9	-1.7

Source: SEB

IN OCTOBER, MARKETS WERE SUBDUED by discussions about the US federal government's debt ceiling and the potential withdrawal of monetary policy support (quantitative easing). However, concerns eased at the end of the month, and since then the markets have picked up speed. This has created better conditions for many hedge fund strategies, which will gradually be reflected in performance numbers. We see fairly good potential for strategies supported by a stable underlying market with a clear pattern, for instance in credit funds that invest in corporate bonds and in many funds with equity-driven mandates.

Hedge fund managers in general often benefit from a good climate in capital markets. When risk appetite picks up among market players and managers are more invested, returns are often better. In a stable climate, the difference between how various assets perform widens – that is, correlations decrease. Lower correlations give hedge fund managers greater potential for a good return on their strategies, since pricing is determined by fundamentals rather than psychology and investor fear, something that has been difficult to assess in recent years. Hedge funds are an important tool for controlling risks in portfolios and for achieving the desired return profiles. In the current climate, with extremely low bond yields, that is even more important. The market potential for hedge fund investments is good. We are moving towards a financial climate with hopefully fewer risks in the nature of "the euro collapsing" or "the Chinese economy making a hard landing". In a more stable climate such as this, risk appetite increases and the above-mentioned conditions fall into place.

Low bond yields also provide new potential to some extent. Virtually every portfolio manager uses standard tools such as diversification, risk control and varied sources of returns. In today's climate, with low bond yields that are expected to rise, managers around the world have to look for other alternatives besides bonds to diversify away from their equity holdings, if only to maintain risk control. That is one explanation for the large inflows seen by global hedge funds this year. Total capital invested in hedge funds worldwide has climbed over the past five quarters, with growth seen in every hedge fund category, although more capital flowed into equity-based funds in the last quarter. One interesting phenomenon is that in the past month we have seen a rise in the number of hedge fund players in China. This is because a new customer category of capital owners is seeking new investment opportunities.

With favourable global conditions now in place in terms of increased geopolitical stability and a generally improved economic picture, market risks have fallen (for instance, measured by the VIX volatility index). This produces greater return differences between asset classes, lower correlations and more opportunities for hedge funds to generate returns. However, there are still significant differences between various strategies.

Our view of the different approaches:

Equity-based strategies (equity long/short)
As a result of improved risk appetite, there is greater potential for good stock-picking, which means that strategies based on fundamental equity analysis have a greater chance of succeeding. Stabilisation in the euro zone and China are one underlying factor. HFRX Equity Hedge has risen almost 9 per cent over the past year, and one factor behind its strong performance is indeed the less volatile market, which makes it easier for managers to generate returns by taking specific risks in the market, that is, through stock-picking. As long as the market trend is stable, this potential will remain.

Relative value strategies
Strategies whose returns are based on finding price differentials between various assets – arbitrage – also benefit from increased risk appetite, since price movements between different assets (for instance, convertible securities and equities) are larger. This type of strategy depends on a volatile money and bond market. Overall, our relative value strategy has generated a rather weak return so far this year (+2.1 per cent). The explanation for this is that central banks have in many cases set their benchmark interest rates at extremely low levels, which affects securities of different maturities, not just those with the shortest maturities. As a result, the yield gap between short- and long-term securities as well as the gap between different credit risks is "squeezed" and the differences become too small for investors to find opportunities. There is better potential in the credit portion of this type of strategy, where we also see good potential going forward.

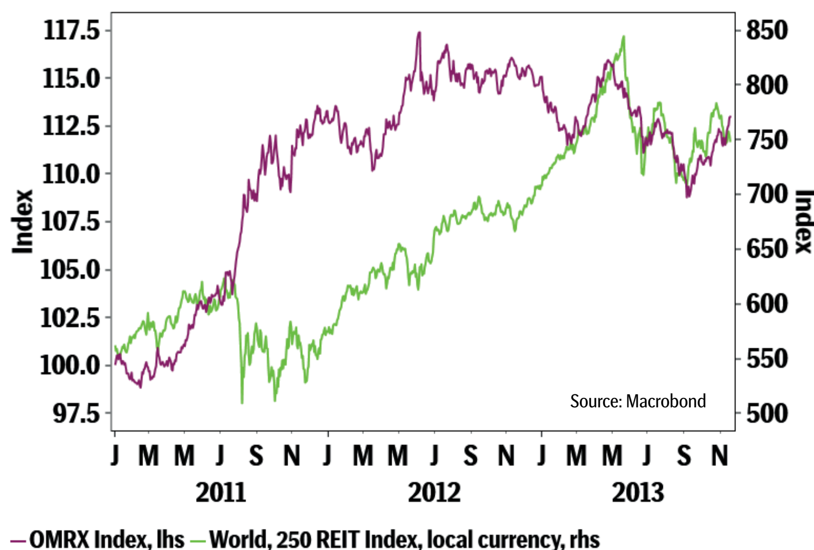
Event-driven strategies
This is another type of strategy that benefits from increased risk appetite in the market, since the number of transactions between companies (such as mergers and acquisitions) tends to increase in this kind of climate. Such transactions offer fertile ground for event-driven strategies. We are already seeing an increase in M&A deals and a generally higher level of activity. The increase has been greatest in the US, but the trend will spread to Europe. Event-driven strategies are one of this year's winners (+12.9 per cent), and the potential for generating returns should not deteriorate going forward. Companies have large cash holdings, and their willingness to invest will increase as the economic recovery continues.

Global macro funds and CTA strategies
A generally better economic trend creates potential for funds in our global macro strategy that move freely between different strategies and asset classes such as currencies, equities, bonds and commodities. Asset pricing is usually a function of the general economic trend. Strategies that follow trends, such as CTA, have had a hard time finding good long-term trends given the situation in today's market. They work better in the opposite situation, that is, when correlations and volatility increase. The return for this category of funds has lagged the most, -2.1 per cent this year, a weak figure explained mostly by the fact that macro strategies that systematically follow trends have had a tough time finding good trends to take advantage of.

Risk appetite still rising in the search for yields

- **Rising home prices will benefit US economic recovery**
  The housing market affects both consumer confidence and the credit market. Rising collateral values make banks more willing to lend capital, while giving households more consumption capacity.
- **High risk appetite and low yields point towards alternative asset classes**
  Continuing high risk appetite has increased investor interest in properties in regions such as southern Europe.
- **Sizzling Chinese housing market causing concern**
  Arguments can be found both for and against a growing housing bubble in China.

REIT INDEX HAS REFLECTED LONG-TERM BONDS SINCE SPRING



Since May this year, the trend for the global REIT index (GPR 250 REIT Index in local currencies) has followed the broader fixed income market, based on the performance of long-term bonds (OMRX T-bonds Index).

THE YEAR TO DATE HAS BEEN DOMINATED by strong risk appetite, driven by low interest rates and central bank quantitative easing (QE). Ben Bernanke, Chairman of the Federal Reserve (Fed), has commented on the market's reliance on QE on several occasions this year. Interpretations as to when the Fed will begin to taper or phase out its bond purchases have led to increased volatility, mainly in peripheral markets. Rising long-term yields have also affected prices in the global property market.

In the last issue of *Investment Outlook*, we described how the search for returns has continued to drive investors further out on the risk scale. We also explained how the close connection between this asset class and the credit and fixed income markets will be affected to a large degree by future monetary policy.

Real estate investment trusts (REITs) are listed securities that invest in either physical properties or mortgage-backed securities. Investments in physical properties generate a return from rental income, whereas investments in mortgage-backed securities generate a return from coupons. In other words, the return for this type of investment depends on the trend for both housing prices and interest rates.

The strong recovery in the US housing market contributed to the rise in REIT prices during the spring and summer. In the US, single-family home prices in the 20 largest cities were up almost 13 per cent between August 2012 and August 2013. The housing market price trend is an important driving force in the country's economic recovery, since it affects consumer confidence as well as the credit market. With rising confidence levels, banks are more willing to lend capital while households have more consumption capacity.

We also wrote in September about the growing presence of institutional investors in the real estate market. Their interest in alternative sources of returns has helped to create significant price pressure from buyers in the US housing market. Purchases of homes in large blocks by institutional investors have reduced the supply available to private individuals, resulting in further price rises. This type of block purchase has also brought increased volatility to the market as a whole. The standard deviation for the global REIT index (GPR 250 Index in local currencies) since early 2009 has been about 19 per cent, compared to 15 per cent measured since 1990.

Transaction volume is benefiting from the growing number of institutional and private investors reallocating capital from fixed income investments with lower returns to alternative sources of returns such as real estate. Global transaction volume was up 16 per cent in the third quarter compared to the same period last year, a good sign that the global recovery is on the right track.

The low interest rate environment and the appeal of real estate as an alternative source of returns have long kept down the return potential in markets and regions that are considered safe. Greater risk appetite has helped to generate increased interest in regions such as southern Europe, where prices have fallen to attractive levels given the prevailing situation.

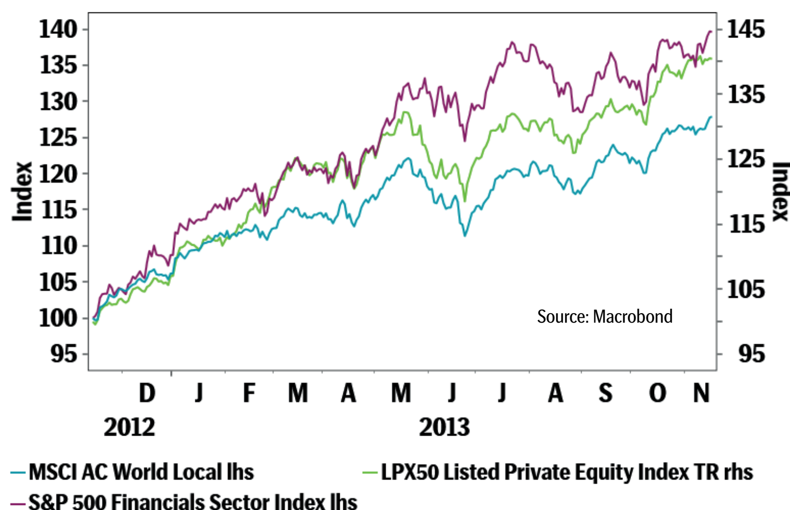
Concern about runaway home prices in China has recently coloured investors' views about the economic trend in that country. According to a report from E-House China, home prices have risen 10.5 per cent over the past year. However, efforts by the Chinese authorities to rein in prices seem to have failed so far. *Forbes* reported that in some Chinese cities there are four empty homes per resident, and on average 15 per cent of homeowners own two or three homes. At the same time, rising wages and significant differences between housing markets in the Chinese interior and in regions surrounding big industrial cities where supply and demand are in equilibrium are arguments supporting the idea that this trend is not necessarily unsustainable.

Worries about reduced stimulus measures have helped to push up interest rates. Especially in recent months, listed real estate companies have shown great sensitivity to interest rate movements. Prospects going forward will be largely determined by monetary policy moves, but the interest in markets such as southern Europe is a good sign that investors believe in more fundamental improvements.

Funding through PE companies generates value

- **Continued high level of activity benefits private equity**
  Strong risk appetite has benefited private equity (PE) through increased transactions, which is also reflected in the growing number of initial public offerings (IPOs).
- **Risk appetite in the hands of the Federal Reserve**
  The Federal Reserve's upcoming tapering of its quantitative easing programme will probably result in a more cautious approach to risk.
- **Large funding gaps are creating opportunities**
  Since it can be challenging to find funding, private equity is playing an increasingly important role in the economy. Meagre government resources further point towards an increased level of private funding.

TAPERING WORRIES ARE HITTING PRIVATE EQUITY HARDEST



The index for listed private equity is up just over 40 per cent in the past year. Worries stemming from Fed Chairman Ben Bernanke's statement in May had a more negative impact on PE, which as a rule is riskier, than on the index for financial shares, which is up about 45 per cent in the past year.

THE PRIVATE EQUITY (PE) MARKET, as investors know, is dependent on general risk appetite. This year, risk asset prices have been fuelled by the accommodative monetary policies of leading central banks as well as by signs of a clearer economic recovery. The continued low-interest environment has also helped make the return potential for risk assets even more attractive relative to low-risk investments.

Nevertheless, worries about the US Federal Reserve (Fed)'s upcoming tapering of its quantitative easing programme have left their imprint on the market's approach to risk. Comments by the soon-departing Fed Chairman, Ben Bernanke, contributed to falling risk asset prices and rising interest rates early last summer. However, Janet Yellen, who has been nominated to replace him, appears to takes a more sceptical stance to starting the tapering process too soon, raising market hopes that stimulus measures will continue for a while.

In the last issue of *Investment Outlook* (published in September 2013), we described how strong risk appetite has created opportunities for PE companies to cash out of mature portfolio companies in the exit market. This continues to be a theme in the broad PE market, and risk appetite also contributed largely to a growing market for initial public offerings (IPOs) both in the US and Europe.

According to a report published by the consulting firm Ernst&Young Global Ltd, IPOs backed by PE companies account for 36 per cent of the global IPO market in 2013 (to September 30). The number of PE-backed IPOs in the second quarter this year was the highest in two years. However, market worries about the Fed's upcoming tapering of its quantitative easing programme helped to reduce activity slightly in the third quarter. So far this year, the number of PE-backed IPOs is 28 per cent higher than in the same period of 2012, and the total value this year is 77 per cent higher than in the same period last year. Activity in the transaction market is thus good, which ultimately benefits the PE market.

The contribution of PE companies to the global recovery is far from insignificant. We generally know the names of listed companies that affect our everyday lives in various ways, but there is rarely the same level of awareness about the impact of privately held companies. One interesting manifestation of this could be followed on the social network Twitter. Wall Street Journal MoneyBeat (@WSJMoneyBeat) reporter Becky Pritchard (@beckspritchard) tried to live one week without private equity. Her tweets make clear how important PE companies actually are in our everyday lives, for instance, in terms of communication, clothing, food and medicine. The wide array of PE-backed brands attests to the importance of the PE industry to the economy and growth.

Infrastructure is another sector where we believe PE companies could grow over the next few years. Significant maintenance needs, combined with strained government budgets and low interest rates, will probably create good opportunities for PE companies. In an article on CNBC's website ("Private equity sees opportunity in all things that crumble" from November 15, 2013), a managing director of the hedge fund and PE credit firm Mariner Investment Group notes that the World Bank and the World Economic Forum have estimated the total volume of project finance debt issuance to be in the range of USD 205-370 billion annually. Meanwhile, the total need is expected to be USD 2.8-3 trillion annually until 2030. The current government financial situation is thus contributing to a large funding gap. Together with continued low borrowing costs, this could be interpreted as opening opportunities for the world's PE companies.

Good risk appetite during the year has continued to benefit private equity. At this writing, the index for listed PE (LPX50 Total Return Index) is up just over 40 per cent in local currencies compared to a year ago, versus a price rise for global equities of about 30 per cent, measured by the MSCI All Country World Index in local currencies. It is also worth noting that this strong performance has been achieved at a historically low level of volatility. Over the past year, the VIX volatility index has fluctuated around 14, compared to the historical average of 21 (measured since 1993). For listed PE, the standard deviation has been 12 per cent over the past year, compared to 19 per cent measured since 1993. The corresponding figures for the broad equities index (MSCI World) is 9 per cent for the past year versus almost 15 per cent since 1993.

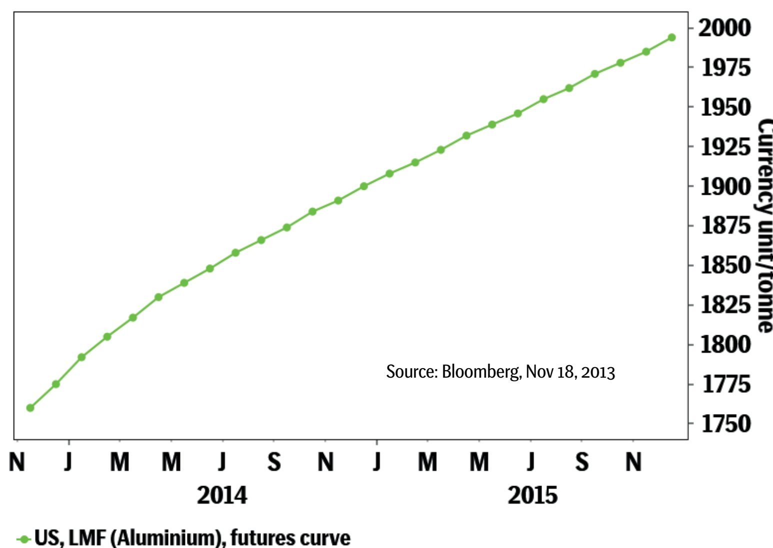
Given the high level of activity and an increasingly apparent economic recovery, prospects for the broad PE market look bright. However, if risk appetite fades, for instance as the result of a Fed decision to begin tapering quantitative easing, volatility – especially among listed PE companies – would increase more than in the broader stock market. But assuming a longer investment horizon, there are good reasons to take advantage of the value being generated in the PE market, which will continue to grow in importance.

Commodities

Lower return potential for commodities

- **No dramatic change in oil prices**
  Saudi Arabia is expected to adjust production to keep the market in balance. Assuming that no dramatic geopolitical events alter the current situation, we anticipate that oil prices will remain at today's levels a year from now.
- **Supply has caught up with demand for industrial metals**
  We believe supply will grow faster than demand in 2014. Metal prices will be somewhat higher, but the slope of the forward (futures) curve indicates reduced return potential. Marginal production cost will limit the risk of falling prices.
- **Concentration of supply and low prices create potential for platinum**
  Recurring miners' strikes and unprofitable mines will inevitably have an impact on platinum prices in the long term. An improving economy in Europe will also provide support, since a key application for the metal is catalytic converters for diesel engines.

SLOPE OF FORWARD CURVE INDICATES REDUCED POTENTIAL



The chart shows how the forward curve for aluminium is in contango (sloping upward). The same situation holds for most industrial metals. This means that anyone who wants to invest in aluminium, for instance to be delivered at the end of 2014, has to pay considerably more than the current spot price, at this writing around 8 per cent. Investments in metals are usually made in the futures market, although it would be possibe to buy the physical metal.

OUR FORECAST FOR THE THIRD QUARTER this year was that the price of Brent crude oil would be USD 105/barrel, but as a result of turmoil in Libya, the actual price was USD 110/barrel. That country's current oil production is about 250,000 barrels per day, compared to a peak of 1.6 million barrels. The current level is comparable to that in 2011, when the country was rocked by unrest and the overthrow of Muammar Gaddafi.

In 2014, we expect daily oil production to increase by 1.7 million barrels among non-OPEC members and 300,000 barrels among OPEC members, while demand will increase by 1.1 million barrels per day. That means a surplus of 900,000 barrels per day, which we believe Saudi Arabia will adjust to by decreasing production. The country has room to reduce its output, since it currently produces about 10 million barrels per day, its highest production rate in 30 years.

As a result, we believe that Brent oil will be trading at around USD 105 /barrel a year from now. However, there are geo-political risks/opportunities that have the potential to either sharply raise or lower prices. Developments in Iraq constitute the biggest upside risk. So far, terrorists have concentrated on bombing pipelines in the northern parts of the country, which has not disrupted production to any great extent. However, should attacks target the southern areas around Basra, the consequences would be dramatic. Escalating turmoil elsewhere in the Middle East could also push prices up.

On the other hand, if most of the unrest that is keeping production down (in Iraq, Iran, Sudan, South Sudan, Egypt and Libya) were to ease, the oil supply could potentially increase by 5-6 million barrels per day – an imbalance that Saudi Arabia is probably not prepared to remedy on its own. The country would then most likely let oil prices fall towards USD 75 USD/barrel in order to force other OPEC members to the negotiating table to achieve an agreement on quotas.

No longer as optimistic about industrial metals

Our current forecast for industrial metal prices has been adjusted downward compared to a quarter ago. One reason is that we have lowered our forecast for nickel by about 10 per cent as a result of developments in Indonesia. The country is a major exporter of ferro-nickel (a mixture of iron and nickel), and we previously believed the country would introduce export restrictions on the metal, which now seems increasingly unlikely.

In 2014 we expect sharper growth in demand than in 2013, although we believe that supply will grow even faster as earlier investments now start to have an impact. This is also the case for copper, where we expect a balanced market for the first time in many years.

The risk of sharp price declines is limited by the fact that marginal production costs are higher than current prices for every industrial metal except copper. We expect industrial metal spot prices to rise 6-7 per cent over one year, but forward curves are in contango (upward sloping), which indicates there is significantly less return potential.

Glittering industrial metal among precious metals

Do not expect any dramatic movements in gold prices over the next year. In our view, gold will trade around the current price of USD 1,300/oz at the end of 2014, unless sharply higher inflation expectations change this picture. However, we think platinum is attractive. About 65 per cent of global production is used for other applications than jewellery, including 40 per cent for diesel catalytic converters, which makes the economic situation in Europe important. Some 70 per cent of global production takes place in South African mines, and workers there are extremely disgruntled with working conditions, which is why strikes keep breaking out. The challenge for these mining companies is that every mine is operating at a loss, given current platinum prices, while workers are demanding higher wages – a situation that in the long run will inevitably lead to higher prices.

Weather can potentially change outlook

Assuming that weather phenomena such as El Niño and La Niña or other unpredictable weather factors do not disrupt the picture, we do not expect any dramatic changes in grain prices generally over the next year.

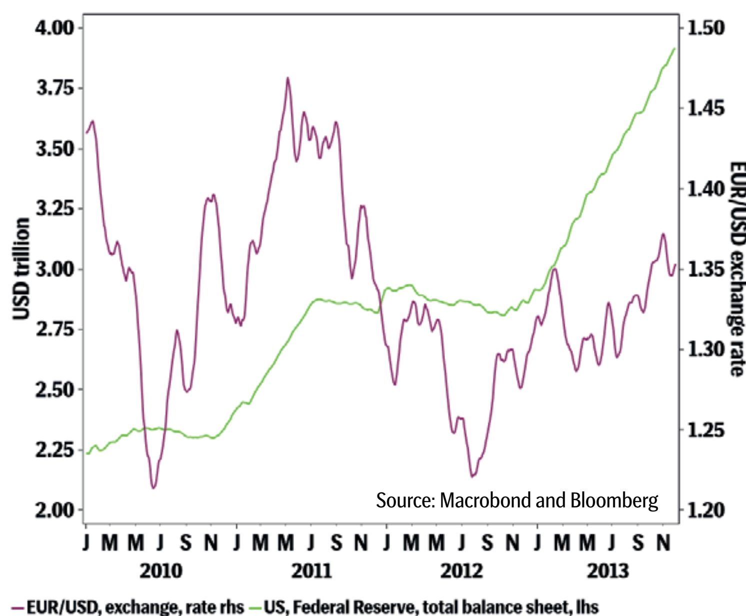
ASSET CLASS	WEIGHT*	REASONING
Energy	1 2 3 **4** 5 6 7	Geopolitical storm clouds at the current level and Saudi Arabia acting as usual will mean unchanged oil prices a year from now.
Industrial metals	1 2 3 4 **5** 6 7	Supply will catch up with demand. Some potential for higher prices, which will be partly offset by the slope of the forward price curve.
Precious metals	1 2 3 **4** 5 6 7	If inflation worries do not increase, we expect gold prices to be unchanged. Platinum prices have upward potential, driven by the concentration of supply and unprofitable mines.
Agricultural products	1 2 3 **4** 5 6 7	At an aggregate level, only unfavourable weather conditions would change our scenario of unchanged price levels next year.

** "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.*

Movements reflect central bank policies

- **Three-way drama focused on monetary policy**
  The major currencies – the USD, EUR and JPY – are driven largely by the monetary policies of their countries' central banks. Massive asset purchases by the Bank of Japan point towards a weaker yen, and further monetary easing from the ECB should lower the euro, while Fed policy will first keep the US dollar weak before then helping to strengthen it.
- **Some saving grace for the USD**
  The large, sustained current account deficit in the US requires funding from foreign investors. If there are any repeats of October's big battle in Washington, investor interest will probably cool, which would weigh down the USD.
- **Stronger currencies in Sweden and Norway – a little later on**
  Both the Swedish and Norwegian central banks have encountered unexpectedly weak economic growth in 2013 and have thus maintained a soft tone in their monetary policy guidance, which has weighed down their countries' currencies. In the short term, the SEK will fall further if Sweden's Riksbank lowers its key interest rate, but an improved economy in 2014 would result in a stronger SEK and NOK.

FED ACTION ON BOND PURCHASES HAS GREAT IMPACT ON THE DOLLAR



The actual and especially the expected monetary policy actions of the Fed are clearly apparent in the EUR/USD exchange rate. When the Fed warned late last spring that it would probably begin tapering its stimulative bond purchases in the autumn, the dollar strengthened, while the decision announced in September to delay tapering caused the dollar to weaken.

CENTRAL BANK MONETARY POLICIES are still among the most important driving forces behind what happens to the USD, EUR and JPY. In particular, expectations about what will happen with the US Federal Reserve's current USD 85 billion per month bond purchase programme have had a considerable impact on the foreign exchange (FX) market in 2013. Signals that the Fed will reduce these purchases have strengthened the USD, while announcements that purchases will continue for the time being have weakened the currency.

At this writing, our main forecast is that a tapering of bond purchases will be deferred until March next year, a view bolstered by statements from Fed Chairman-designate Janet Yellen in an appearance before the Senate Banking Committee in mid-November. If confirmed, she will become Chairman on February 1, 2014. In essence, she argued that the advantages of the prevailing Fed policy outweigh the disadvantages and that the US economy needs to be on a more solid footing before that policy is reconsidered.

Assuming that the FX pattern that has held for most of 2013 continues, the **USD** will remain weak for a while. But as the Federal Open Market Committee (FOMC) meeting on March 18-19 draws near, that trend will probably start reversing. The USD will be bolstered in 2014 and early 2015 by a less accommodative monetary policy, and in the second half of 2015 it will be supported by expectations that the Fed will be one of the first big central banks to introduce substantial tightening. Our forecast is that the federal funds rate will be raised from 0.25 to 0.50 per cent in late 2015.

Another long-term factor in the USD's favour is the prospect of a significant acceleration in US growth over the next few years. That will buoy the country's labour market, which in itself will lessen the need for continued monetary stimulus. A higher growth rate than in the euro zone and Japan, for instance, would also probably lead to international capital flowing into the US to a greater extent. During the spring and summer this year, the **EUR** benefited from signs that the euro zone economies were poised for better times. Euro zone GDP started to grow in the second quarter after six straight quarters of decline, and indicators have signalled continued growth going forward. However, recent euro zone economic data have been less uniformly positive. Combined with the fact that the region is still wrestling with economic, financial and political problems, these constitute negative factors for the EUR. If the European Central Bank (ECB) introduces a negative deposit rate at the same time as there is an increasing probability that the ECB will adopt a bond purchase policy similar to the Fed's current programme, the EUR will tumble further.

The **JPY** will be weighed down over the next year by the Bank of Japan's aggressive monetary policy, which includes massive asset purchases. In the longer term, growing questions about the ability of "Abenomics", the government's strategy to revitalise the economy, to implement reform policies could also weaken the JPY. So the Japanese currency will come under pressure if domestic bond investors are not satisfied with a real interest rate of about minus 1.4 per cent (assuming inflation reaches the 2 per cent target) and instead sell their bonds on a large scale and turn to capital markets abroad.

The **SEK** has lost value in 2013 following repeated disappointments over growth figures for Sweden, and foreign investors have given up on speculation that the Riksbank will raise its repo rate. If, according to our forecast, the Riksbank instead cuts its repo rate from 1 to 0.75 per cent in December, the SEK should weaken further in the short term. Supported by better growth both worldwide and in Sweden, the SEK will then appreciate in 2014.

This year, Norges Bank has encountered unexpectedly weak Norwegian economic growth and a volatile inflation rate, a difficult environment for monetary policy. By all indications, the central bank will leave its key interest rate at 1.50 per cent for the next year, a far higher level than for many other central banks. This, together with prospects of higher growth in Norway next year, bodes well for the **NOK**.