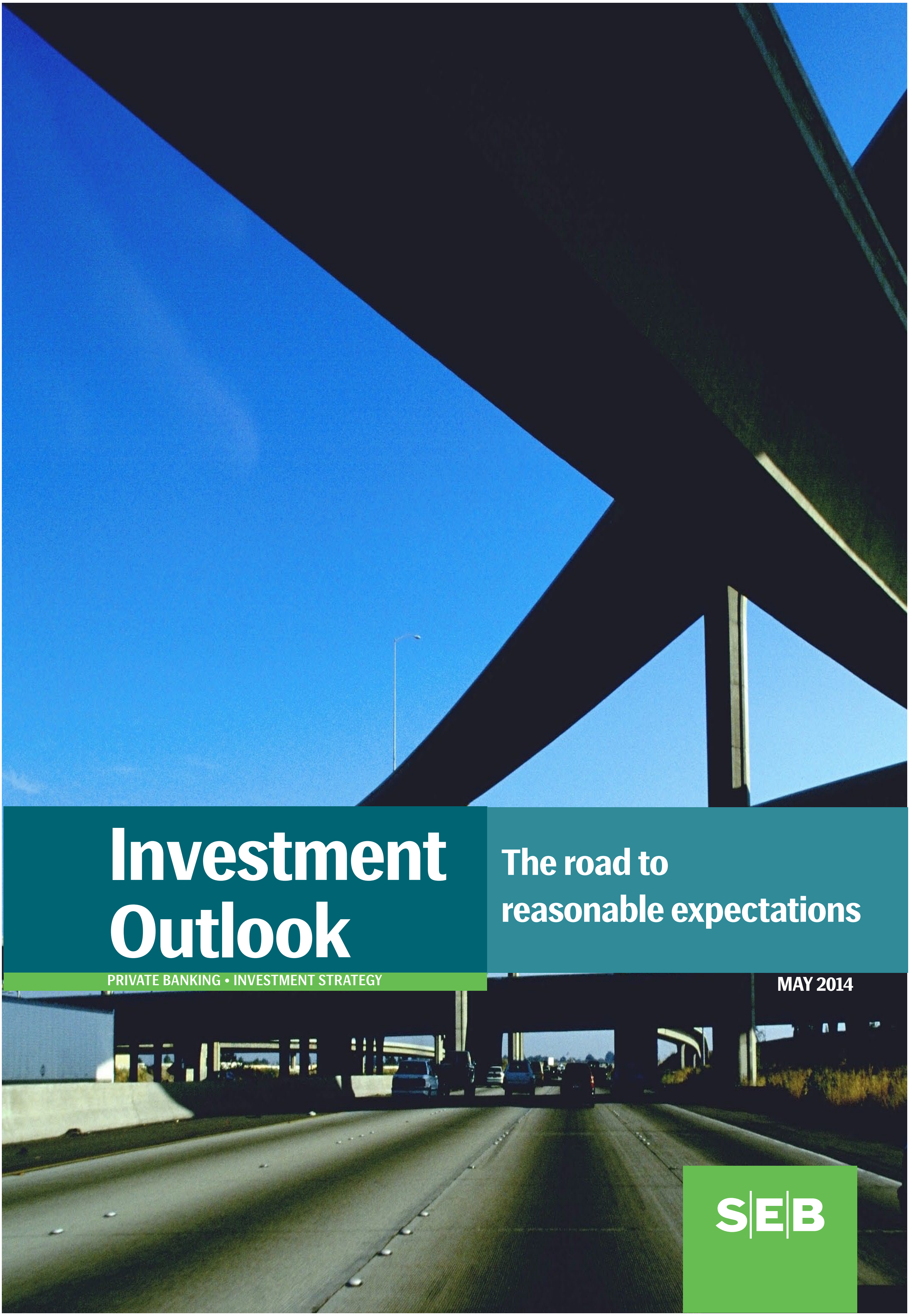

Investment Outlook

The road to reasonable expectations

PRIVATE BANKING • INVESTMENT STRATEGY

MAY 2014

SEB

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The road to reasonable expectations

What can go wrong in a world of extremely low interest rates, decent economic growth, expansionary central banks, stable stock markets and high risk appetite?

Many curves are undeniably pointing in the right direction and many asset classes are showing optimism. Meanwhile we have seen increased geopolitical worries, and the share valuations in some places are challenging.

So how should an investor navigate in this environment? Are high valuations the same as large downside risk? How much risk should you take in your well-diversified portfolio? How can you ensure returns in a fixed income portfolio, given today's low bond yield situation? There are many questions, and the challenges are clear. Important in this type of market is to have reasonable and realistic expectations. We discuss this in our theme article "Time to adjust return expectations".

Higher expected returns are connected with higher risk-taking: "There are no free lunches". Sometimes it makes sense to increase the risk in a portfolio on a broad basis, if the expected additional returns can provide a clear contribution. At present, however, we prefer more selective risk-taking. Some risks are worth taking, others not.

Stock markets have continued to perform well, although with clear differences between geographic markets. First quarter 2014 corporate reports indicated some stabilisation, although many did not meet analysts' earnings expectations. Certain signals were clear, however. For example, many companies saw positive signs in European markets, and this bodes well for the future. Meanwhile, share valuations in many places are a bit strained. This is rarely the same as a clear downside for the stock market, but it still means that upside potential is somewhat limited and it raises the question of how to handle investments in the fixed income market. Short-term interest rates are still very low. Looking ahead, bond yields will probably climb in response to stronger global growth. High yield corporate bonds have worked well for a long time, but the yield spreads between government bonds and corporate bonds have narrowed, and the same applies to the return potential.

In the search for returns, the fixed income market has continued to evolve. In our theme article "Challenging yield environment raises questions", we look closely at the long-term prospects in the fixed income market and some of the investment alternatives that are available.

Our overall assessment is that return expectations must become more nuanced. Assets with high valuations remain attractive, but their high valuations limit potential. Meanwhile the fixed income market offers few options for those looking for returns. This challenging market climate requires selectivity and precision.

ANN GREVELIUS
Global Head of Investment Strategy

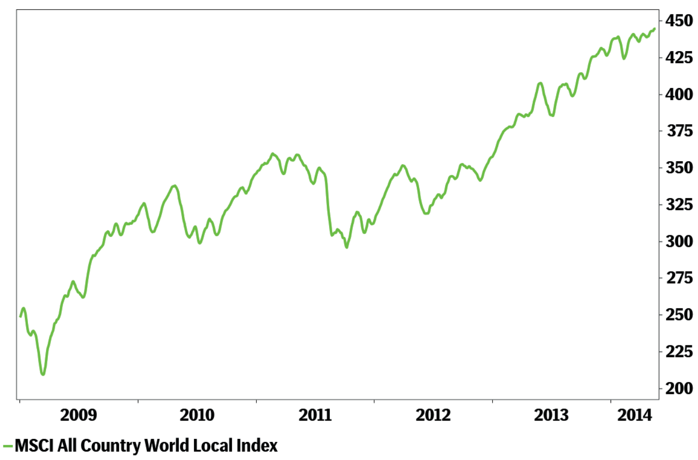
Selective risk-taking in a challenging market

During an economic recovery, a stock market often moves in three phases. The first phase is driven by increased risk appetite as a result of decreased anxiety as well as low interest rates and yields, which drive return-seeking capital into equities. The next phase begins when the economy stabilises and expectations about interest rate and yield trends change, often leading to a calmer stock market. The final phase begins when credit expansion has gained momentum and investors say "this time it's different, stock markets will keep climbing indefinitely" – which does not happen...

We are now at the beginning of the second phase. The economy has stabilised, the United States Federal Reserve is gradually "tapering" its purchases of bonds, thereby reducing its support to financial markets. Now stock markets must begin to "stand on their own feet", carried forward by steadily improving corporate earnings. The latest quarterly reporting season signalled that in the US, there are relatively good conditions for this to happen. In Europe, the signs are gradually improving. Earnings will climb once the economy has stabilised further.

Having concluded that we have moved from one phase to another, it is important to see which markets and assets were in focus during the previous phase and assess which ones will be in focus in the next phase. Bonds have been a core investment for a long time, but now the levels of return from this type of securities are clearly lower. Some portions of stock markets have been driven up to high levels, while in others there are still opportunities to find lower-valued markets and/or sectors. One such example could very well be regions that are categorised today as crisis-hit, such as parts of China and Asia. However, we must identify what will trigger a change in valuations. To be attractive from an investor's perspective, there has to be faith in an improved fundamental trend. In the case of China, such a signal could be that commodity prices are not falling further.

We see this as a period during which we gradually phase out some of the asset classes that have been performing well for a long time and successively steer our portfolios towards cyclically driven investments. Depending on the type of mandate, we will take risks that may be perceived as somewhat higher, but where the return potential of the assets we are phasing out is too poor nowadays, perhaps even negative, which is a risk in itself.



Source: Bloomberg

TIME FOR STOCK MARKETS TO STAND ON THEIR OWN FEET

Economic conditions have stabilised, the US Federal Reserve has reduced its bond purchases and stock markets must now be carried forward by better company earnings. The potential for this to occur is relatively good both in the US and Europe.

EXPECTED RISK AND RETURN IN THE NEXT 12 MONTHS

Our risk and return expectations are taken from the SEB House View. These expectations cover the next 12 months.

ASSET CLASS	EXPECTATIONS NEXT 12 MONTHS		COMMENT
	RETURN	RISK	
EQUITIES	9%	13%	Expected risk and total return for global equities, measured using the MSCI All Country World Index in local currencies.
FIXED INCOME			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.
Bonds	2.0%	5.0%	
Cash	1.0%	0.1%	
HEDGE FUNDS	4%	5%	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	10%	14%	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	-4%	15%	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 1.32 (-3.8%), EUR/SEK 8.90 (-0.9%) and USD/SEK 6.74 (+3.0%).

MAIN STRATEGIES IN OUR PORTFOLIO MANAGEMENT

- **Risk-friendly despite high valuations**
  Basically, we are in a phase that is friendly towards risk-taking, although a number of major stock markets have high valuations, which limits their potential to some extent. But the combination of low interest rates/yields and low economic growth is steering capital towards stock markets, which can remain highly valued as long as there is good growth. Valuations as such will not reverse this trend.

- **The decline in interest rates and yields is not sustainable – the trend will be rising long-term yields**
  Interest rates and yields have fallen sharply – especially in Europe – on expectations of low inflation, European Central Bank actions and worries connected to the Ukraine crisis. Looking ahead, this is not a sustainable pattern and we believe that the decline should reverse.

- **Shrinking yield spreads will mean poor returns on bonds**
  Yield spreads between corporate and government bonds have become very narrow. They can certainly shrink somewhat further, but returns in relation to risks are very low. We are referring to both the risk of rising yields and to some extent credit risk (for those who invest in individual bonds).

- **There are pockets of value for those who dare to defy convention**
  In the sequential economic recovery, with US consumers acting as an economic engine and other parts of the world following, pockets of value are created in a world of otherwise rather high valuations. This provides opportunities for those investors who dare to defy conventional wisdom, "contrarian investors". We allow this approach to be reflected in our higher-risk mandates.

- **Sectoral and regional rotations can be expected as the economy stabilises**
  When markets are no longer driven to the same extent by high liquidity, but by a stable economy that is based more on fundamentals, there will be a focus on traditional sectors and countries. Europe is one such example, and at the sectoral level we expect a shift from growth companies to more cyclical ones.

- **China the key to emerging markets**
  So far, the emerging market (EM) recovery is more of a market movement than one based on fundamentals, except in foreign exchange markets where high interest rates have provided better conditions. Looking ahead, developments in China will be a key factor behind a stable recovery. For the time being, Asia is our favoured EM region.

ASSET CLASS	WEIGHT*	REASONING
Equities	1 2 3 **4** 5 6 7	Looking ahead a bit, brighter economic prospects and global growth will have an impact on corporate earnings. Equities will then probably enjoy support from earnings, which will be adjusted upward. At present, the upside is limited by high valuations. Europe is our preferred region.
Fixed income	1 **2** 3 4 5 6 7	Gradually higher world economic growth and fading geopolitical tensions will lead to rising developed market (DM) government bond yields during the next couple of years. Because of rapidly shrinking yield spreads against government bonds, the best period for corporate bonds is now behind us.
Hedge funds	1 2 3 **4** 5 6 7	Strategies with a fundamental valuation approach will continue to pay good returns. Event Driven strategies are benefiting from corporate transactions, while trend-following strategies such as CTA are having more difficulty since trend shifts have been large and rapid.
Real estate	1 2 **3** 4 5 6 7	Improvements in fundamentals are easing concerns about interest rates/yields and are driving the real estate investment trust (REIT) market. Temporarily falling long-term yields also supported REIT investments during the first quarter.
Private equity	1 2 **3** 4 5 6 7	Assuming continued good risk appetite among investors, the private equity (PE) market can continue to bring in large capital gains. Because of increased risk appetite, beta is lower versus the stock market.
Commodities	**1** 2 3 4 5 6 7	Extraordinary events such as the Ukraine crisis, mining strikes in Africa and an Indonesian export ban on nickel ore have had an impact on commodity prices, which have climbed on a broad front.
Currencies	1 2 **3** 4 5 6 7	There are many indications that the USD will appreciate against the EUR and JPY. An expected Swedish key interest rate cut will weigh down the SEK this summer, but in 2015 the SEK will bounce back as the Riksbank switches monetary policy and begins hiking its key rate.

Source: SEB

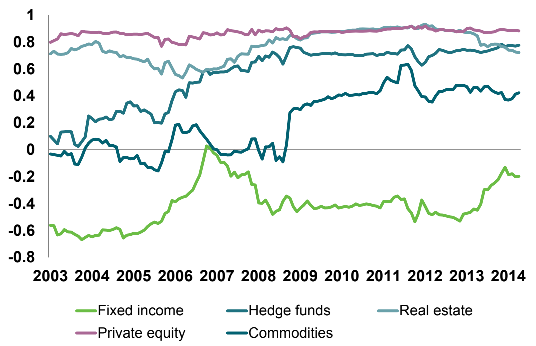
** "Weight" shows how we currently view the asset class as part of a portfolio. Level 4 is a neutral stance. These weights are changed continuously, based on our tactical market view, and may thus diverge from our long-term strategic view of an asset class. At the customer level, portfolios are tailored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

HISTORICAL CORRELATION (MAY 31, 2004 TO APR 30, 2014)

	Equities	Fixed income	Hedge funds	Real estate	Private equity	Commodities
Equities	1.00					
Fixed income	-0.33	1.00				
Hedge funds	0.71	-0.36	1.00			
Real estate	0.84	-0.12	0.57	1.00		
Private equity	0.87	-0.32	0.70	0.87	1.00	
Commodities	0.35	-0.25	0.66	0.30	0.41	1.00

Source: SEB

ROLLING 36-MONTH CORRELATION VS. MSCI WORLD



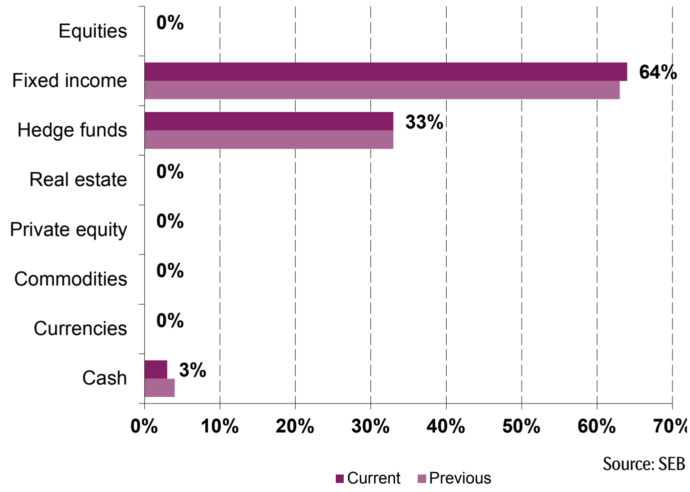
Historical values are based on the following indices: Equities = MSCI AC World EUR; fixed income = JP Morgan Global GBI EUR; hedge funds = HFRX Global Hedge Fund USD; real estate = SEB PB Real Estate EUR; private equity = LPX50 EUR; commodities = DJ UBS Commodities TR EUR.

Source: SEB

MODERN INVESTMENT PROGRAMMES
– ALLOCATION OF CAPITAL ACROSS ASSET CLASSES AT THREE RISK LEVELS

MODERN PROTECTION

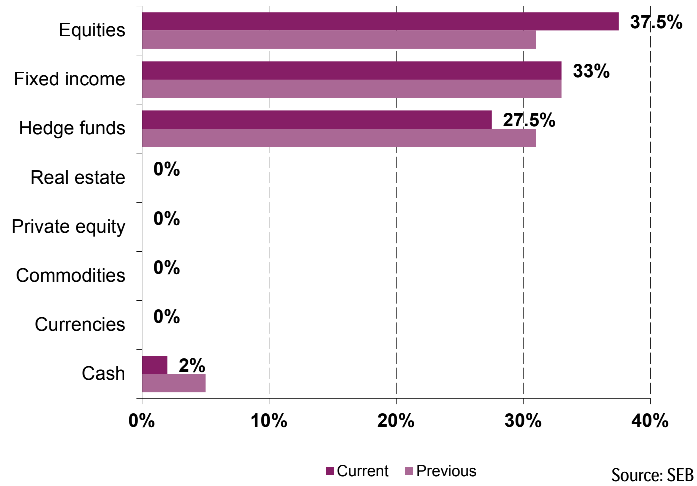
Modern Protection continues to generate returns in line with our expectations, and we have not made any major changes so far during 2014. Credit Long/Short, which accounts for about 18 percent of the portfolio, has contributed about half of this year's total returns. MultiStrategy (5 per cent) and Equity Market Neutral (10 per cent) have remained around zero. In our unchanged fixed income sub-portfolio, Absolute Return makes up 26 per cent of Modern Protection, followed by senior loans/high yield (12 per cent), short-term bonds (9 per cent), investment grade Libor (5 per cent) and money market (9 per cent). All sub-components contributed positively. Our managers continue to deliver in line with our expectations and the various asset classes complement each other well. We anticipate continued stable returns ahead.



Source: SEB

MODERN GROWTH

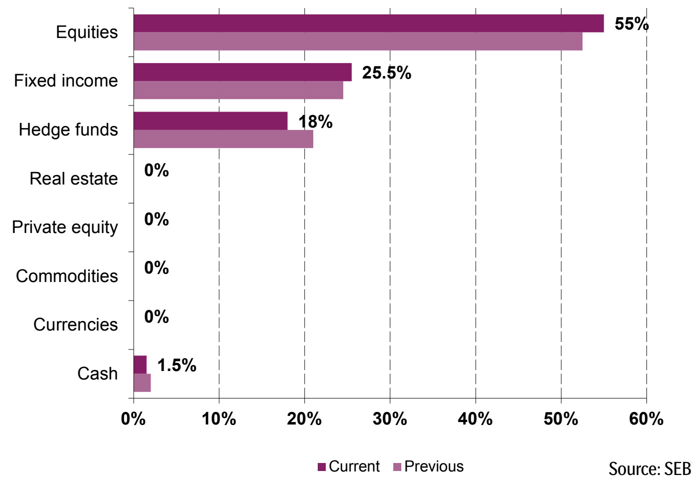
In Modern Growth, we try to balance between two conflicting forces – global economic acceleration (which continues to favour risk assets) and relatively high valuations, which make the long-term outlook for returns appear limited. As a result, we have increased Modern Growth's equity holdings in recent weeks and they currently account for more than 37 per cent of the portfolio. In fixed income, we see limited potential for high yield ahead, and we have instead enlarged our holdings of convertible bonds and started taking small positions in emerging market corporate bonds (3 per cent) and contingent convertible bonds or CoCos (3 per cent). Our total allocation to fixed income is largely unchanged and represents about one third of the portfolio. The hedge fund sub-portfolio (about 27 per cent) emphasises Credit Long/Short and Equity Market Neutral, followed by Event Driven and MultiStrategy.



Source: SEB

MODERN AGGRESSIVE

During most of the first quarter we had a cautious view of equities, but we have started to gradually increase shareholdings in anticipation of a more favourable macroeconomic environment in the second half. To gain extra leverage we have invested in European small caps, since these tend to be more sensitive to the domestic economy. We have also bought Chinese large cap index funds, dominated by sectors rejected by investors in recent years, such as financials. We expect a trend reversal, driven by more growth-oriented policies and the recapitalisation of banks. In fixed income, we have made moves similar to those in Modern Growth, that is, a decrease in high yield, an increase in CoCos and purchases of EM corporate bonds, but we have also invested in emerging market local debt (2.5 per cent). EM currencies have continued downside risk, but running yields of about 9 per cent are attractive and offset this risk in the long term. The main emphasis of the hedge fund sub-portfolio is on Credit Long/Short.



Source: SEB

Time to adjust return expectations

Choosing the right portfolio risk is largely based on expectations about the future. Today we are probably standing on the threshold of a more challenging investment climate.

One of the world's best-known bankers, John Pierpont (J.P.) Morgan, is said to have told a friend who was so worried about his shareholdings that he could not sleep, "Sell down to your sleeping point." Finance professor Burton G. Malkiel puts it this way: As an investor, you have to decide whether you want to eat well or sleep well. Choosing the right portfolio risk is largely based on expectations for the future. Today we are probably standing on the threshold of a more difficult investment climate.

As an investor, you expect a positive return. Otherwise there is no reason to make your investment. First and foremost, you expect to be paid at a risk-free interest rate for the period during which you abstain from your capital. In addition, an investor wants to be compensated for the risk that a given type of investment represents: its risk premium. No matter where we are in the economic cycle, an investor needs to consider a few things that will largely define potential returns:

1. How the allocation between different asset classes should look over time. This decision is based on risk tolerance and investment horizon. So-called **strategic allocation** is the long-term asset class allocation that defines the risk in a portfolio.

2. When the investments should be made. So-called **tactical allocation** is active or passive divergence from long-term asset class allocation.

3. What investments will generate the **best potential within each asset class**.

Strategic allocation should guide expectations

The starting point for structuring a portfolio is choosing among asset classes, often called strategic allocation. A portfolio traditionally contains equity investments and fixed income investments. Alternative sources of returns such as absolute return hedge funds, private equity, real estate, forestland and commodities are becoming more common elements in private investors' portfolios. Not surprisingly, what strategic asset class allocation a given type of portfolio should maintain over time is dependent on individual factors such as risk tolerance and investment horizon.

By focusing on strategic allocation, you lay the groundwork for the long-term success or failure of your portfolio. By using portfolio optimisation models, investors create portfolios with the highest possible expected return, at the risk level they are willing to accept. In practice this is complicated, however, since risk and return forecasts are all we have available concerning the future. Looking back at history can give us an indication of long-term average values and meanwhile underscore the wide variation in outcomes. In the search for good returns, strategic allocation and time are thus key ingredients.

Tactical allocation

Tactical allocation is about short-term divergences from long-term allocation. These divergences may either be due to active allocation decisions or drift, that is, weight allocations that are attributable to changes in the valuations of asset classes. With the help of macroeconomic and market analysis, we consider making a divergent allocation in order to offset reversals and take advantage of opportunities. It is important to remember that tactical allocation changes the risk level of the portfolio relative to its starting position, and thus also the returns you can expect.

Overvalued markets, especially the stock market, have occasionally created unrealistic return expectations and have thereby misled investors in their tactical decision making. Before 2013, for example, SEB's expected return for the full year on the OMX Nasdaq Stockholm exchange was about 13 per cent, including dividends. The actual full-year 2013 outcome was +23 per cent, as measured by the OMX Affärsvärlden General Index including reinvested dividends. Despite the prevailing overweighting of equities, given today's low market volatility many portfolios seem – at first glance – to be underweighted in terms of risk, relative to the risk that the investor was strategically willing to accept. The expected return on the Stockholm exchange for the coming 12 months is just over 8 per cent, including dividends. Outperformance compared to the risk that was taken may just as well mean underperformance during another year. Based on the risk that investors were strategically willing to accept, over time it is easier to know which risk is worth taking in order to increase potential extra returns.

Three decades of favourable conditions

Interest rates and long-term yields in the Western world are at historically low levels, and the perception among investors about where we are today in the economic cycle is quite divided. If we look at developments over the past 30 years, we note that it has been very rewarding to invest in financial markets. Compared to even longer historical time series, the past three decades have been special in the sense that both equity and fixed income markets have provided very good returns.

Among the factors that have contributed to the favourable investment climate has been active inflation-fighting. Together with reduced regulation and fast-growing globalisation, this has increased incentives for companies to improve their efficiency and boost their profitability. Extremely low valuations combined with increased earnings created favourable conditions and growing inflows into the stock market. Gradually falling interest rates, combined with financial deregulation in the early 1980s, led to enormous pressure in the credit market and rising risk asset prices. In the early 1990s monetary stimulus measures started becoming increasingly popular, and they have fuelled investors' risk appetite until today.
A risk-free return varies along with changes in the prevailing interest rates and has historically often been in the 3-5 per cent range, but sometimes – like now – it is much lower. The risk premium is expected market return minus risk-free return. Measured from 1920 until the end of 2013, the average historical risk premium in the Swedish stock market has been 3 per cent, measured as the difference between the annual return on the Affärsvärlden Composite Index and the Swedish 10-year sovereign bond yield. If we shorten this to the past 30 years the risk premium has averaged more than 8 percent, and in the past five years more than 15 per cent. One clear trend in the past 30 years has been the gradual decline in interest rates and yields, causing the market's expected return on equity investments to rise.

Rising risks

Investment advisors have traditionally advocated optimal allocations between stocks and bonds. A traditional US portfolio, for example, has had a strategic allocation of 60 per cent equities, 20 per cent Treasury notes and 20 per cent Treasury bills. Over the past 30 years, both stocks and bonds have paid good annual returns and the portfolio has provided returns of more than 9 per cent annually. Measured over the past 30 years, portfolio risk – measured as standard deviation – has been more than 13 per cent. In other words, annual returns have varied greatly. For example, in the traditional portfolio's worst years it showed a negative return of 27 per cent. If we look at the past five years, average annual return has held steady, but at a considerably lower risk. Instead, the portfolio's annual returns during this period varied within the 4-24 per cent range, which in itself may be the basis for understated risk estimates. Low measured risk actually increases the probability of rising future risk.

	30 YEARS			5 YEARS		
Investment	**Nominal yearly return**	**Real yearly return**	**Yearly standard deviation**	**Nominal yearly return**	**Real yearly return**	**Yearly standard deviation**
US equities	10.6%	7.9%	17.4%	12.4%	10.9%	11.5%
US 10-year Treasury notes	7.5%	4.8%	10.1%	3.3%	1.8%	11.5%
US Treasury bills	3.8%	1.1%	2.7%	0.1%	-1.5%	0.0%
Portfolio 60% equities, 20% Treasury notes, 20% Treasury bills	9.4%	6.7%	13.4%	10.5%	8.9%	7.6%
Average US inflation	3.3%			2.1%		

Source: SEB and Macrobond

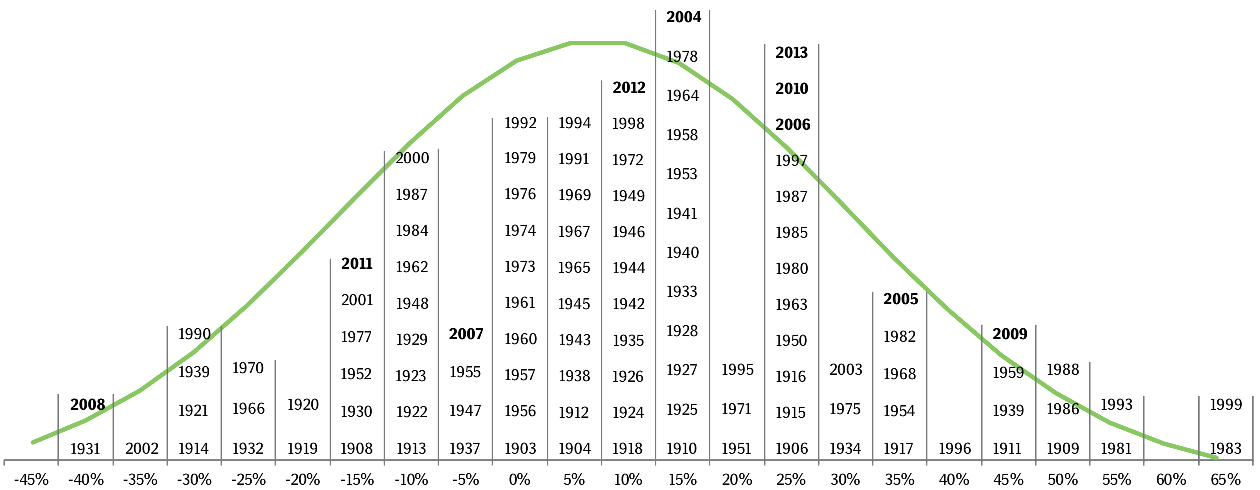
Taking the current stimulative low interest rate/yield environment into account, there is reason to believe that over certain periods, investors have chosen to tactically diverge from strategic allocation. If this has been done in favour of increased risk-taking, in some periods it has paid off, in others not. The performance pattern of Sweden's OMX Affärsvärlden General Index demonstrates the concept of mean reversion, which implies that over time we are expected to revert to the mean. Nominal annual return since 1902 has been 7.4 per cent. This is a good return, but the normal distribution makes it clear that this is just a geometric mean with considerable variation, both on the upside and downside. Risk amounts to 23.8 per cent, measured as one standard deviation. This measure includes bad years like 2011, but does not take into account the crisis years 2008 and 1931.

Strategic portfolio weighting will lead us forward

If inflation falls further in the Western world, we will reach deflation. This would be disastrous for global growth and the stock market. In other words, the inflation targets of around 2 per cent that are set by leading central banks will probably become increasingly important in the future. As for interest rates, key rates in the range of 0 to 0.25 per cent in the US and the euro zone mean that rates can largely only move up. Interest rate hikes will probably take longer to materialise in Europe, given its continued slow economic recovery and deflation worries, but rising bond yields can be expected in the next couple of years. Stock market valuations will also be adversely affected by rising interest rates and yields. In the stock market, companies will probably maintain a tighter grip on costs, but their opportunities to improve their margins to the same extent as in the 1990s and 2000s will be more limited. High valuations compared to historical averages, especially in the US, clearly show the downside risks in the stock market, although the current low interest rate/yield climate has the potential to continue pushing up valuations a bit more.

The above factors, together with historically low volatility, suggest that market performance during the next couple of years will not be as generous as in the last couple of years. As long as the low interest rate/yield environment continues, we will tactically overweight risk. Given rising interest rates and yields, return expectations in the bond market will be significantly lower than we have become accustomed to in recent years. In the stock market, we have already witnessed a rotation from growth companies to more mature sectors with lower growth. The financial markets are probably headed for a climate that will gradually shift to being driven by improvements in fundamentals, rather than by added liquidity from central banks. In such a more "normal" climate, it is time to adjust return expectations downward, while the importance of selectivity and alpha generation will increase. As we approach a trend shift, the importance of active diversification will increase, and selection of risks should always be made in light of strategic allocation.

GREAT VARIATION AROUND THE MEAN IN THE SWEDISH STOCK MARKET



Source: SEB and Macrobond

The chart shows the annual returns for Sweden's OMX Affärsvärlden General Index between 1902 and 2014 as a normal distribution. Each year's return has been categorised in rounded-off annual returns on the horizontal (x) axis and frequency on the vertical (y) axis. We can conclude that the outcomes are concentrated around the mean, 7.4 per cent, and that the further out in the normal distribution "tails" we move, the less likely or common these outcomes will be. However, it is important to note that they do exist.

Challenging yield environment raises questions

For the past century the government bond market has been cyclical, with periods of falling yields/rising prices alternating with periods of rising yields/falling prices. From the 1920s onwards, the pattern has been remarkably regular, with cycles spanning 30 years.

The early 1950s until well into the 1980s saw rising yields/falling bond prices, making it a 30-year "bear market", with very low returns on bond investments. Underlying factors included rising inflation and rapidly growing demand for loan capital to finance investments related to post-war reconstruction and the higher growth and good economic times that prevailed in the 1950s and 1960s.

On the threshold of the 1980s, bond yields had been pushed up to records highs and central banks began a major tightening of their monetary policy. This strong central bank reaction rather quickly achieved its intended result: inflation and inflation expectations began a clear decline a few years into the 1980s.

This downward movement in inflation persisted over the next few decades, paving the way for a 30-year "bull market" in bonds with falling yields/rising bond prices. During this period, returns on bonds were very good. This was especially true of the period after the turn of the millennium, when the total nominal return on investments in US Treasury bonds added up to nearly 135 per cent, a historically high return for such a period.

Judging from history, after thirty years of falling government bond yields a new bear market for bonds is now imminent. Our assessment is that the bond market is currently in a transition period, especially since government bond valuations in the developed market (DM) sphere are historically high. According to SEB's forecast, returns on investments in US, euro zone and Swedish government bonds will be negligible or even negative during the coming year.

There are many reasons to expect higher yields in the bond market on both sides of the Atlantic, including stronger economic conditions, diminishing financial risks that make safe government bonds less attractive, the "tapering" of Federal Reserve bond purchases and future expectations of rising inflation/less concern about deflation.

However, our forecast does not include any sharp upturn in government bond yields. The risks of significantly higher DM inflation are small, as long as there is plenty of spare production capacity. In addition, the European Central Bank may very well follow the example of other leading central banks and launch large-scale bond purchases this summer. Overall, monetary policies in both the US and Europe will remain historically stimulative for another year or so.

The main threat to our scenario would be if economic conditions unexpectedly weakened and the deflation threat became more serious than we currently expect – a combination likely to cause government bond yields to fall instead.

Those fixed income investors who are now considering Treasury bill purchases in the US or European money markets should expect very low returns over the next 12 months. The reason is that conventional central bank monetary policy will continue to be characterised by unprecedentedly low key interest rates. In a few cases, interest rates may even be cut further in 2014. The first rate hikes look set to occur in the spring (Norway) and summer (US, UK) of 2015.

For many years, the returns on investments in corporate bonds – investment grade and high yield – have been substantially higher than on investments in DM government bonds. In the past two years or so, however, a significant drop in bond yields in what were once acute problem countries – Greece, Ireland, Italy, Portugal and Spain – have turned government bonds in these countries into worthy competitors of corporate bonds.

Recently, as yield spreads between corporate and government bonds have narrowed further, the attractiveness of investment grade in particular, but also of high yield bonds, has faded. Although these spreads may shrink a bit more in both the US and Europe, this would seem to be mainly due to a rise in government bond yields and less due to a decline in corporate debt yields. In that case, there will be ever-diminishing scope for further price gains on corporate bonds.

Emerging market debt (EMD) still offers fixed income investors the prospect of good returns, especially after bond yields in the EM sphere rose sharply during the summer and autumn of last year. For example, Brazilian ten-year government bond yields rose from 9 per cent in early 2013 to nearly 13.5 percent a year later. However, EMD is also associated with significantly higher risk (particularly with regard to exchange rate movements) than the assets described above, so EMD is hardly an alternative for investors who seek low risk in their fixed income portfolios.

The above outlook for fixed income investments thus does not seem especially good, implying that there are major challenges ahead for those who seek this type of investments for various reasons. The question "Are there any other fixed income investment alternatives available?" is justified. If we study funds with free investment mandates and a focus on fixed income investments, we may be able to identify suitable holdings in "contingent convertibles", "leveraged loans" and "convertible bonds".

Contingent convertibles (CoCos)

One of the more attractive alternatives in the fixed income market today is the contingent convertible (CoCo), a bond issued by banks that in many cases replace today's perpetuals.

A bank's capital structure consists of core Tier I capital – retained earnings plus share capital – but also of a number of buffers that can be drawn upon if the bank becomes insolvent. Capital from CoCos is one element of these buffers. Many investors have good experience in buying debenture loans issued by banks. The purpose of this new type of loan is to enable a bank to access capital when all other possibilities are exhausted. These capital buffers are designed to increase the stability of the banking system.

There are mainly three types of CoCos:

1) At a certain point, the nominal amount is converted into share capital, with the conversion price specified in the terms and conditions.

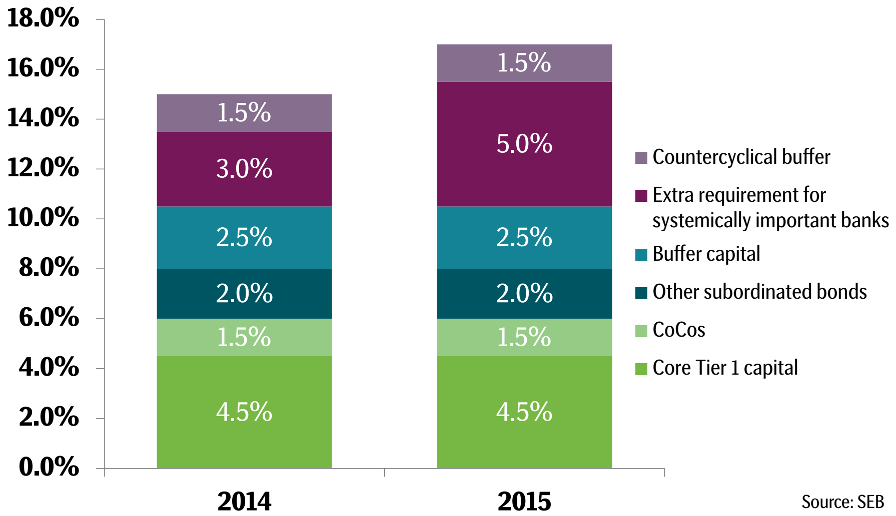
2) The nominal amount is written down completely.

3) The nominal amount is written down over a certain period, and when the bank achieves positive earnings, the value is written up again.

Being able to transform the nominal value of a convertible bond into share capital is a new phenomenon in these contexts. If the bank's total capital ratio falls below a certain predetermined level, it triggers this function, leading to a high core Tier I capital ratio for the bank.

A CoCo can be perpetual, and the bank must specify in its documentation when it can be repurchased (call date). This can be done no earlier than after five years and no later than 15 years after issuance. When pricing a CoCo, investors should be compensated for the risk that the bond will be converted into shares or fully written down, or that the investor will lose the coupon and value during a given period. They should also take into account that this type of bond is high on the risk scale, just behind share capital.

RAPID REINFORCEMENT OF A BANK'S CAPITAL STRUCTURE



Source: SEB

Swedish and Norwegian banks are ahead of many competitors elsewhere in Europe in terms of meeting the new capital adequacy rules, but no Swedish banks have yet issued CoCos, which fulfil an important function under these new rules.

Leveraged loans: Investments in bank loans

The market for "leveraged loans" (also called "bank loans", "senior loans" or "buy-out loans") is comparable in size to the high yield market.

Issuers are usually highly leveraged companies, and the buyer of such a loan must be prepared for the potential bankruptcy of the issuer. This means, on the other hand, that the interest rate you earn for lending money is relatively high. The loans are reported as a balance sheet item in the accounts of the issuers. In the case of banks, for example, increased EU regulations and requirements that shrink balance sheets have led to greater interest in leveraged loans. This is because the banks spin off individual loans and resell them to funds seeking returns from fixed income investments in today's low bond yield environment.

When funds invest in leveraged loans, they buy loans on which the principal is being repaid and that also pay interest. Their maturities are between five and ten years, but the loans can also be redeemed early, so the duration is usually shorter. The return is often linked to the three-month London Interbank Offered Rate (LIBOR) in USD, which ensures low volatility and low interest rate risk.

This market is likely to keep growing as long as the supply of cheap liquidity does not shrink and investors wish to diversify their portfolios. The spread between government and corporate bonds has narrowed very quickly, which means that this type of investment will become even more widespread. Banks also need to clean up their balance sheets as a result of new regulations that are being implemented.

Convertible bonds – convertibles

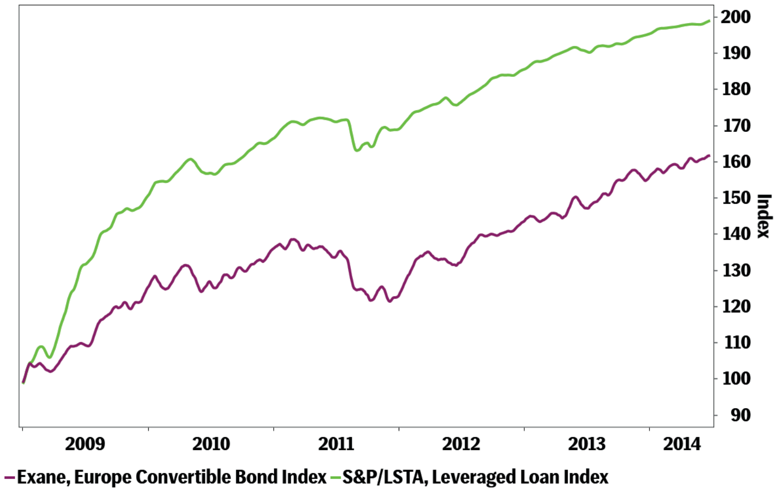
We can summarise this product as a combination of a corporate bond and a call option on an equity – a hybrid product. Issuers typically have a low credit rating (BB+ and below) but at the same time high growth potential. Convertibles offer a lower coupon rate than comparable bonds, because investors are offered an unlimited upside potential if the bond is converted into shares. In order to provide an attractive alternative to buying shares, they pay a higher dividend yield than shares. The buyer receives coupon payments on the bond until conversion takes place, and this gives the investor downside protection.

This type of bond is not a new phenomenon in the capital market. The first convertibles were created as early as the mid-19th century in the United States. However, the market is relatively small (estimated at less than USD 50 billion) and in Scandinavia very few convertible bonds have been issued.

Conclusion

To summarise, the probable trend shift to gradually rising government bond yields over a long period will mean that the number of attractive fixed income investments will shrink. This applies especially to interest-bearing government bonds of various types, but also corporate bonds (especially investment grade). To many investors, emerging market debt may seem a bit too risky. But there are alternative fixed income investments worth considering, and among these we believe that contingent convertibles are the most interesting.

HIGH RETURNS ON CONVERTIBLE BONDS



Source: Bloomberg

Between January 2009 and May 2014, investments measured by the S&P/LSTA Leveraged Loan Index provided a return of about 60 per cent, driven by bank divestments of loans from their balance sheets. Convertible bonds, measured using the Exane Europe Convertible Bond Index, paid a return of about 35 per cent during the same period.

Eastern Europe – big east-west differences

Eastern (including Central) Europe is a region full of differences. The economies bordering Germany are expected to show further improvements, while the Ukraine conflict is creating tensions in large parts of the former Soviet Union. Below we analyse Eastern Europe's most important countries, with Russia and Poland dominating financial markets and in terms of GDP.

Since Russia annexed Crimea in mid-March 2014, with tensions flaring up in eastern Ukraine, the conflict has constituted the most serious geopolitical risk in a very long time. Great drama has also historically gripped this part of the world. Events more than 20 years ago have a significant bearing on Russia's actions today under the leadership of President Vladimir Putin.

The fall of the Berlin wall on November 9, 1989 was a key event that heralded revolutionary changes in Eastern Europe (then the Eastern block), culminating in the dissolution of the Soviet Union on December 26, 1991. The results of this dissolution were 15 countries (the Russian Federation, Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Tajikistan, Turkmenistan, Ukraine and Uzbekistan). There are significant Russian-speaking populations in many of these countries, some of which are now agitating for separatism after the events in Crimea during the spring. This is illustrated by the so-called referendums for independence recently held in the Donetsk and Luhansk regions in eastern Ukraine.

A look in the rear-view mirror of history also shows revolutionary events elsewhere in the former Eastern block. Foremost among them are the peaceful division of Czechoslovakia into the Czech Republic and Slovakia in late 1992/early 1993 and the highly dramatic developments in the Balkans, with the Yugoslav wars, which in 1992 led to a number of former provinces becoming independent states.

Today 29 countries can be considered part of Eastern Europe. Twelve belong to the Commonwealth of Independent States or CIS (Russia and eleven other former Soviet republics). The other 17 are categorised as emerging and developing Europe, including Poland, the Czech Republic, Romania and the three Baltic countries. In this analysis, we have chosen to exclude Turkey from Eastern Europe.

Eastern Europe – a small part of the EM sphere

In macroeconomic terms, 2013 GDP (current prices adjusted for purchasing power parities) totalled USD 3,655 billion in the CIS and USD 2,633 billion in the rest of Eastern Europe. In other words, Eastern Europe's GDP last year was USD 6,288 billion, or about 14 per cent of total GDP for emerging market (EM) countries as a whole.

Growth in Eastern Europe during 2012 and 2013 was far slower (2-2.5 per cent yearly) than in the EM countries overall (almost 5 per cent). This pattern will persist in 2014-2015, based on current International Monetary Fund (IMF) forecasts (April 2014). Other IMF estimates for 2014-2015 show that Eastern Europe is performing rather well compared to EM countries as a whole with respect to inflation and public finances, whereas a current account deficit is predicted for Eastern Europe, in contrast to a surplus for the EM sphere as a whole.

Russia-Ukraine conflict is constraining growth

The ongoing Russia-Ukraine conflict mainly hurts the two countries' economies, but also leads to economic setbacks elsewhere in Eastern Europe, especially certain former Soviet republics in Central Asia plus Bulgaria and the Baltics. Negative effects occur especially via foreign trade (for instance, 19 per cent of Lithuania's exports go to Russia and just over 31 per cent of imports come from there), but also via lower optimism, hampering private consumption and capital spending activity. Russia, moreover, is being hit by economic sanctions against key individuals and companies imposed by the US/EU in response to Russian aggression against Ukraine.

However, in our view, the Russia-Ukraine conflict (provided it does not escalate) will not significantly slow the economic upswing that began last autumn mainly in Central Europe, especially since higher growth in Germany and elsewhere in Western Europe is generating increased demand for Eastern European goods and services.

The five largest economies represent almost 70 per cent of Eastern Europe's GDP

In 2013, the five largest Eastern European economies in GDP terms were Russia (USD 2,556 billion), Poland (817), Ukraine (337), the Czech Republic (286) and Romania (285). These five countries thus accounted for a full 68 per cent of the region's total goods and service production; Russia alone accounted for 41 per cent. In light of this, there is reason to continue focusing our analysis on these economies. In this context it is worth noting that Poland, the Czech Republic and Romania are all members of both the EU and NATO.

Russia – weaker rouble, persistent negative trends

Long before the Russia-Ukraine conflict, Russia's economy showed clear signs of moving in the wrong direction, with falling current account surpluses, weakening government finances and – in recent years – decelerating growth. The reasons are mainly structural – falling investment ratios, unfavourable demographics, heavy dependence on energy (65 per cent of exports are oil/gas and 50 per cent of government revenue comes from the energy sector), and an abysmal business climate. However, not everything is bleak in Russia's macroeconomic world. Central government debt is low, the labour market is strong and the agricultural sector is performing well. The banking sector is also relatively stable and well-capitalised.

In order to accelerate growth to a potential long-term rate of about 4.5 per cent, economic reforms are needed along with a sharp upswing in investments, but at present there are no signs that these conditions will soon be met. Our main scenario is thus that the negative trends in the Russian economy will persist for at least the next couple of years.

Nor is the short-term economic outlook for Russia encouraging. In the best case, the country's GDP will stagnate in 2014. A recession cannot be ruled out in the wake of sustained capital outflows, share price declines and falling real investments. Should oil prices fall more than expected over the next year – say, below USD 100 per barrel – the country's economy and finances would be weighed down even more. The weakening of the rouble since the turn of the year – which is expected to continue – has led to higher import prices, fuelling inflation. In response to growing inflation risks, the Russian central bank twice raised its key interest rate, and more hikes are in the cards.

Poland – lower public debt, higher domestic demand

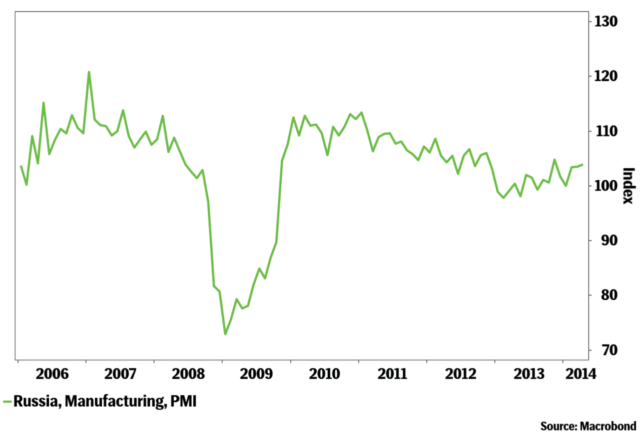
Poland's economy is in a completely different, better situation. Poland was the only EU country to avoid recession during the financial and economic crisis of 2008-2009. Macroeconomic imbalances have narrowed greatly in the past few years. The current account deficit shrank last year to a modest 1.5 per cent of GDP. Public debt – which by Polish law may not exceed 55 per cent of GDP – was impermissibly high last year, but thanks to fiscal tightening and radically new steps (including the transfer of a large percentage of private pension fund assets to the state), that debt will fall this year to around 50 per cent of GDP. The underlying public budget deficit is still undesirably large (just over 3 per cent of GDP).

Poland's economic recovery, which began last year, was initially export-led. The country benefits from a large trade surplus with Germany (25 per cent of exports go there, while 21 per cent of imports come from there) and other Western countries. It has limited dependence on Russia (just over 5 per cent of its exports go there, while 14 per cent of its imports come from there). Domestic demand is also gradually picking up, as reflected in rising consumer confidence and increased retail sales.

Inflation in Poland is low, and well below the central bank's 2.5 per cent target. The key interest rate was rapidly cut from 4.75 per cent in late 2012 to a record low 2.5 per cent last summer. Judging from low inflation, the bank will not start hiking rates until next year. Poland's economic situation is favourable in many respects, pointing towards zloty appreciation over the next year. The currency has successfully withstood concerns about the EM sphere since the summer of 2013.

Ukraine – falling GDP, rising inflation

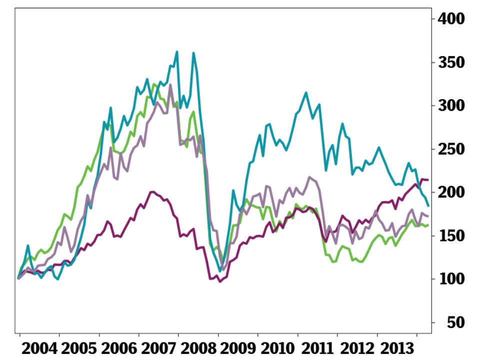
The situation and prospects for the third largest Eastern European economy – Ukraine – are in many ways alarming. This is illustrated by an accelerating current account deficit, which reached almost 10 per cent of GDP in 2013, and by a forecasted 6 per cent drop in GDP this year, combined with a surge in inflation to 6 per cent (from slight price decreases in 2013). The rise in inflation is largely due to a roughly 30 per cent collapse in the country's currency, the hryvnia, against the USD as a result of the conflict with Russia.



REVERSAL FOR RUSSIAN INDUSTRY

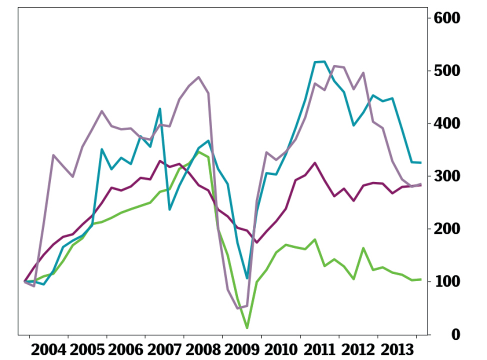
After an upswing in 2009 as the global economy rebounded from a major financial and economic crisis, Russian industrial production has seen a generally declining trend. Based on the latest purchasing managers' index for manufacturing, weakness in this sector will persist going forward.

TOUGH TIMES CONTINUE



The chart shows the share price trend in Swedish kronor. Prior to the financial crisis, the Moscow, Warsaw and Vienna stock exchanges were hot – but unlike the Swedish exchange they did not really recover after the crash.

VOLATILE EARNINGS IN EASTERN EUROPE



The chart shows net earnings indices for the largest listed companies in Poland, Austria and Russia in local currencies, as well as in Sweden for comparative purposes. The faltering performance of Eastern European stock markets over the past decade is largely explained by a decline in relative valuations of Eastern European companies.

The Czech Republic – brighter economic prospects

After a two-year recession, the situation is now brighter for the Czech economy. The foundation was laid last winter when GDP growth accelerated sharply on a broad front. Industrial production has also gained steam recently, and the purchasing managers' index has risen to a high level. However, retail sales have meanwhile cooled slightly, although stable prices have boosted consumer purchasing power.

Like Poland, the Czech Republic currently enjoys a clear advantage from its large trade with Germany – the economic engine of Western Europe – which buys more than 30 per cent of Czech exports (25 per cent of imports are from Germany). Other important countries for Czech exports are Slovakia, Poland, France and the UK.

In terms of macroeconomic fundamentals, the Czech Republic does well in an Eastern European comparison. Its public budget deficit is just over 1 per cent of GDP, public debt is below 50 per cent of GDP, and the current account deficit is close to zero.

However, there is no lack of challenges. In the short term, there is a deflation risk – even though the country's currency, the koruna, has fallen in value for a while (currency stabilisation is our main scenario for the rest of 2014). In the long term, the output gap has to narrow and growth needs to increase by means of measures that increase competitiveness and improve the efficiency of Czech domestic markets.

The Czech central bank cut its key interest rate to 0.05 per cent as early as November 2012, and it is likely to be a while before the first rate hike, especially since inflation will probably remain below the 2 per cent target for a long time and the economy will not accelerate especially fast going forward.

Romania – good shape, room for more stimulus

The Romanian economy – Eastern Europe's fifth largest – is in many ways in rather good shape. Public debt is below 40 per cent of GDP and the public budget deficit is about 1.5 per cent of GDP (with the current account deficit about the same). Financial markets have also given the country good marks; the yield on ten-year government bonds has fallen since early 2012 from 7.5 per cent to about 4.75 per cent. Fresh indicators point to rising industrial activity, private consumption and exports – as in Poland and the Czech Republic, Germany is by far Romania's largest trade partner for both exports and imports. Meanwhile, real inflation (just over 1 per cent), as in many other countries, is below the central bank target (2.5 per cent). Further monetary stimulus measures may well be launched, perhaps mainly in the form of lower bank reserve requirements. The key interest rate today is 3.50 per cent.

Eastern European stock markets

Most stock markets in Eastern Europe are insignificant in size; all but three have a total stock market capitalisation less than SEB's. Russia's is by far the largest, with Poland's solidly in second place, while the Czech stock market is rather large. The other stock markets are fairly small, but in some cases investors who want exposure to the region can find this through companies listed in other stock markets. For instance, many companies listed on the Stockholm and Helsinki exchanges have sizeable operations in Eastern Europe. Along with actual Eastern European stock markets, we believe it is also relevant to include Austria, since the Vienna exchange is dominated by companies with the bulk of their operations in Eastern Europe. Austrian companies have expanded sharply in Eastern Europe since the Berlin wall fell. This is true of banks as well as telecom operators and oil refineries. For the three largest listed companies on the Vienna exchange, Eastern Europe is by far the most important market, and three of the next six companies ranked by size also have a large share of their operations in the region.

Squeezed profitability, high dividend yields

All stock markets in the region are relatively undervalued in an international perspective, but low price/earnings (P/E) ratios have been the norm in Eastern Europe for many years. Apart from in Russia, Ukraine, Romania and Slovenia, P/E ratios have been somewhat higher than average over the past seven years. However, in an international perspective, these ratios are consistently low or very low.

If we instead look at sluggish multiples such as equity valuations relative to average shareholders' equity over the past seven years, then virtually every market is historically cheap. Poland is valued 29 per cent below the historical average, with Austria 44 per cent and Russia 56 per cent below. Dividend yields are also relatively high – over 5 per cent in Russia and over 4 per cent in Poland and the Czech Republic.

Banks and oil

Eastern European stock markets are dominated by mineral extraction and/or financial service companies. In Russia, oil and gas account for more than half of market capitalisation. If we include other commodities, minerals represent more than two thirds of total market cap. Otherwise banks are biggest, especially on the Moscow exchange. The largest listed companies are oil and gas giants Gazprom, Rosneft and Lukoil, followed by Sberbank. Of these, only Lukoil is controlled by private shareholders, while the Russian state owns a majority of shares in the other three. On the Warsaw exchange, banks and financial service companies dominate; 13 banks together account for 30 per cent of free float. If we also include insurance and other financial service companies, the total is 53 companies with an index weight of over 40 per cent. Among the 20 largest listed companies, banks have even greater sway. The four largest companies in Poland are PKO Bank, Bank Pekao, the PZU insurance company and the PGE power company. The two largest banks together have the same market capitalisation as SEB in Sweden.

Banking and finance also dominate the Austrian stock market. The three largest listed companies in Vienna are Erste Bank Group and Raiffeisen Bank International as well as the refinery and oil company OMV. They all have significant operations in Eastern Europe, with a presence in countries like Hungary, the Czech Republic, Slovakia and Romania. The largest company on the Prague exchange is the power company CEZ, followed by Komercni Banka.

Overall assessment

Eastern European stock markets are generally undervalued, so they may seem attractive, but at the same time that is a reflection of the relatively high risk level represented by investments in these markets. There is great potential for price gains if all the storm clouds on the horizon were to disperse, but given the enormous economic and political risks we see in Russia, we believe the risk/return ratio can at best be considered balanced. However, Poland and the Czech Republic are intimately tied to the German economy and other euro zone countries, where the outlook has greatly improved recently. So it is quite likely that the relatively high earnings growth expectations for their listed companies could be realised, while the risk premium may once again shrink. We thus consider the western-most countries in Eastern Europe the most attractive today and prefer investments in Eastern Europe excluding Russia rather than broader investment across the entire region.

COUNTRY	FREE STOCK MARKET FLOAT FOR THE MOST LIQUID EQUITIES, SEK M	P/E RATIO 2014	P/E PREMIUM/ DISCOUNT AGAINST 7-YR DISCOUNT	DIVIDEND YIELD	P/B	P/B PREMIUM/ DISCOUNT	EARNINGS GROWTH 2014, %	EARNINGS GROWTH 2015, %
Russia	3,653,551	5.0	-47%	5.0	0.56	-55%	26	3
Poland	800,506	13.8	18%	4.4	1.29	-28%	4	12
Austria	609,717	13.5	26%	3.0	0.98	-47%	51	28
Czech Republic	362,596	14.4	13%	4.3	1.17	-47%	532	17
Romania	136,808	8.9	-38%	5.0	0.98	-46%	-2	18
Kazakhstan	135,666	6.3	na	3.5	-	na	279	14
Hungary	117,569	11.2	11%	3.3	0.83	-51%	116	18
Croatia	84,649	12.8	63%	3.2	0.92	12%	-7	31
Slovakia	45,287	10.0	-52%	na	0.82	-66%	1	17
Ukraine	36,500	4.2	-74%	2.4	-	-69%	463	19
Baltics	22,251	9.8	28%	5.6	1.30	19%	9	10

This table shows key financial data for the stock markets most important to Eastern Europe. The data include indices for the most liquid equities in each market, which in most cases are similar to those for the market as a whole. The stock markets are small, but all markets have lower or much lower valuations than for instance the Stockholm exchange. Equity valuations are historically low, in part because of squeezed profitability, but analysts expect strong earnings growth in many cases over the next couple of years. Listed companies in Austria, the Czech Republic and Hungary are expected to show high earnings growth both this year and next. We believe that the quality of the forecasts and other data for Ukraine may be significantly affected by the political situation in that country.

Global economy on upward track

- *The pace varies geographically, but the world economy is rising, with the US as an engine*
- *Many EM economies face continued headwinds; as a whole, they may not accelerate this year*
- *Russia-Ukraine crisis poses a major risk*

The world economy keeps climbing, though at varying rates in different regions and with temporary seasonal setbacks, especially in winter and spring. But judging from current indicators, there is now potential for better global momentum, with the US leading the way. In parts of the emerging market (EM) sphere, the upturn is hampered by regulation and structural weaknesses. Yet in general terms, most EM countries have shown good resilience during the conflict between Russia and Ukraine. Although the risk that this conflict will escalate and have a global impact is relatively small, it is still resulting in somewhat larger downside risks for the world economy than before.

US bouncing back after tough winter
Due to unusually severe winter weather, US economic growth largely froze in the first quarter, but recent sentiment points to an imminent economic rebound, with higher household demand as the main engine. We expect GDP to grow by just over 2.5 percent this year and more than 3.5 percent in 2015. Although inflation will speed up, price increases will remain low in the next couple of years. Meanwhile, job growth will be quite high and unemployment will shrink further. We thus predict that the Federal Reserve will continue tapering its bond purchases, ending them in October 2014. We believe the Fed will begin hiking its key interest rate – now 0-0.25 per cent – in the summer of 2015.

Euro zone economy ticking upward
The euro zone is now trending slightly higher. Judging from many indicators – such as the purchasing managers' index for manufacturing – the growth rate is likely to increase. The German economy is showing particular strength, and most GIIPS countries (Greece, Ireland, Italy, Portugal, Spain) have improved their competitiveness. The economies in the eastern part of the euro zone are affected most by the crisis between Russia and Ukraine. While only 3 per cent of Germany's exports go to Russia, the share is 19 per cent in Latvia and over 9.5 per cent in Finland, for example. We predict euro zone GDP growth of 1 per cent this year and more than 1.5 per cent next year. Mounting deflation risks, along with falling bank lending, suggest that the European Central Bank will launch a large-scale bond purchasing programme this summer, while its key interest rate (now 0.25 per cent) is unlikely to be cut further.

Broad-based British expansion
In the United Kingdom, the economy is expanding on a broad front. We predict GDP growth of 3 per cent this year. Despite a minor slowdown, it may end up a bit above 2.5 per cent in 2015. Inflation has been falling for some time and will continue to trend downward. The Bank of England (BoE) is thus in no hurry to tighten monetary policy. Instead, the first hike from today's 0.50 per cent key interest rate will not occur until summer 2015. Rapid home price increases – in London the year-on-year rise is now 18 per cent – are not expected to persuade the BoE to act earlier. If financial stability is challenged, regulatory measures are instead likely to be considered.

Nordic economies follow divergent paths
The economies of the Nordic countries are pointing in slightly different directions and are different in nature. In Sweden, growth is being driven by housing construction and private consumption, while exports are weak. In Norway, good purchasing power and higher home prices point to increased household demand, while falling oil, gas and housing investments will slow GDP growth. The Danish economy is accelerating on a fairly broad front, and current account surpluses are record-high. Finland, however, is lagging because of structural problems in the forestry and information and communications technology sectors; we predict that GDP will fall in 2014 for the third year in a row. We believe overall Nordic GDP will increase by less than 2 percent this year and below 2.5 percent in 2015.

Abenomics not convincing
Growth in Japan – previously fuelled by stimulative monetary and fiscal policies as part of "Abenomics" – lost momentum late in 2013 as the positive impact on foreign trade of earlier yen depreciation faded. The increase in consumption tax from

5 to 8 per cent on April 1 this year is now causing another dip in growth. This is partly offset by infrastructure projects and lower corporate taxes. Whether Abenomics will sustainably boost growth depends on structural reforms, but these are not convincing. According to SEB's forecast, GDP will grow by 1 per cent this year and less than 1.5 per cent in 2015. In the short term, there is a chance that inflation will reach the Bank of Japan's 2 per cent target. It is uncertain whether it will manage to do so in the long term. Long-term inflation expectations are still parked well below target. By current indications, the Bank of Japan is thus likely to expand its securities purchases later this year.

Emerging Asia maintaining its lead

Asia's emerging economies are still growing faster than other parts of the world economy. Most indicators point to gradual acceleration in 2014-2015. GDP in the region is forecast to grow by 6.5-7 percent annually – except in China, where deceleration is expected to continue. Inflation in emerging Asia has recently increased somewhat due to higher food prices, but this does not change the picture of historically low inflation. There is low, stable core inflation in most places.

The Chinese government seems to accept slightly slower growth than its 7.5 per cent target, but if deceleration becomes undesirably large there is room for economic stimulus measures. We predict Chinese GDP growth of 7.2 percent this year and 7 percent in 2015. The slowdown is mainly due to falling capital spending. Commodity-exporting Asian countries such as Indonesia are most affected by this. India is vulnerable because of its large current account deficit. In India there are now hopes that the election victory of Narendra Modi's BJP will lead to reforms and large investments, but these hopes may be exaggerated. We believe India's GDP will grow by 5 per cent this year and above 5.5 percent in 2015.

Latin America grappling with macro problems

The Latin American economy has recently shown macroeconomic problems in the form of slower growth, higher inflation and rising current account deficits. However, fiscal deficits have remained quite modest. Argentina is in trouble, with a combination of falling GDP and accelerating price increases. Brazil is performing decently in macro terms, while Chile and Mexico are faring better. We foresee Latin American GDP growth of nearly 2.5 per cent this year and just under 3 percent in 2015, while the high rate of price increases will ease somewhat next year.

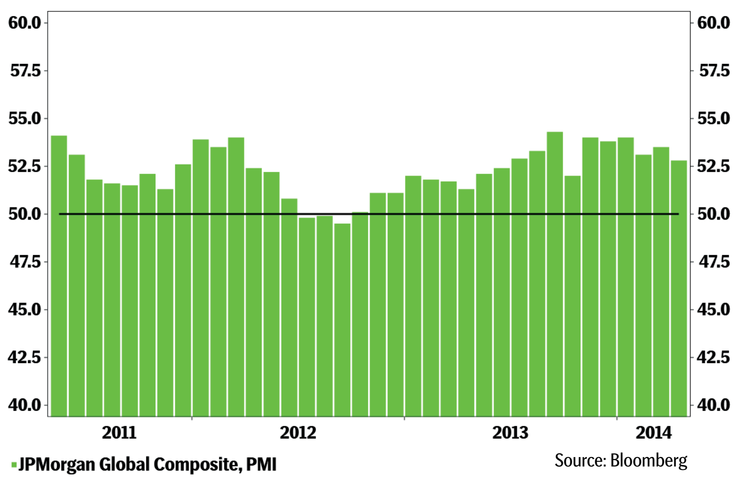
Ukraine crisis casting dark shadows

Military and political tensions between Russia and Ukraine/NATO/other Western countries have increased dramatically since Russia annexed Crimea in mid-March 2014. This tense situation looks set to last, but the likelihood of a Russian military invasion of Ukraine or a disruption of Russian energy deliveries remains small. Both the Western powers and Russia appear highly reluctant to start a trade war. In any event, the crisis will have a negative economic impact across Eastern Europe, especially in Ukraine, where GDP will shrink this year, and in Russia, which is teetering on the brink of recession. The south-eastern part of the region will also suffer noticeably, as will the Baltics (read more in our theme article on Eastern Europe).

The crisis will have a rather deep negative impact on growth in the Baltic countries, mainly through export and investment channels. It may also inhibit growth in the longer term, since trade with Russia is sizeable, especially for Latvia and Lithuania. Yet thanks to domestic buffers – rapid growth in purchasing power, falling unemployment and good household optimism – the risk of recession in the Baltics is small. Strong economic fundamentals in terms of current account balances and government budgets will provide financial resilience.

World growth will gradually accelerate

Global growth will gradually gain momentum. We predict that world GDP will increase by more than 3.5 per cent this year and nearly 4 per cent in 2015, after last year's rate of slightly above 3 per cent. Although the EM sphere will continue to grow the fastest, at 4.5-5.0 per cent yearly in 2014 and 2015, the growth gap to the developed market (DM) sphere will narrow significantly. EM growth will slow a bit this year, while growth in DM countries will surge from just over 1 per cent in 2013 to just above 2 per cent in 2014 and a bit higher than 2.5 per cent in 2015.



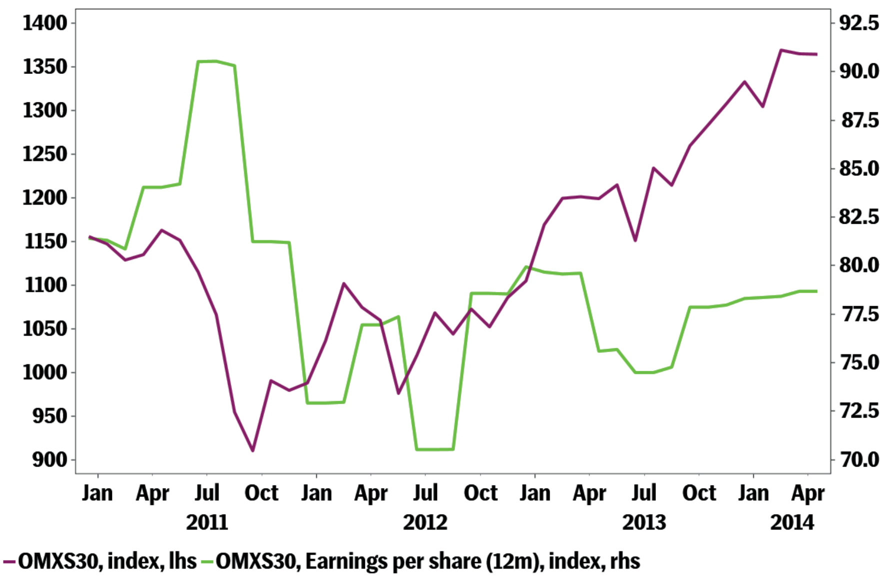
JAPAN BEHIND DIP IN GLOBAL ECONOMIC GROWTH CURVE

Measured by the JPM/Markit global composite purchasing managers' index (manufacturing and services), world economic growth slowed in April compared to March. Behind this was a deceleration in Japan after the consumption tax hike on April 1. Excluding Japan, the global economy rose slightly faster in April.

Europe will save corporate earnings

- **High valuations are holding back the stock market**
  The stock market rally of recent years has not been accompanied by higher corporate earnings. This revaluation has made shares more expensive than for many years.
- **Quarterly profits were again lower than expected, but Europe provides hope for the future**
  After seven lean years, the European market is now reviving. This may mean a long-awaited earnings boost for many listed companies.
- **Monetary policy will keep return requirements low**
  Central bank stimulus measures are keeping interest rates and bond yields low, making the stock market attractive despite the high valuations.

STOCK MARKET RALLY UNSUPPORTED BY EARNINGS



Source: Bloomberg

The chart shows the trend for the OMXS30 index – consisting of the 30 largest companies on the Nasdaq OMX Stockholm exchange – since 2011 and the index of earnings performance by the same companies over the same period. From a low point during the summer of 2011, share prices have climbed about 50 per cent while earnings have declined.

THE REPORTS OF SWEDISH LISTED COMPANIES for the first quarter of 2014 were once again disappointing. Looking at their total earnings, they were about 10 per cent below analysts' expectations, but there were sizeable divergences. There were as many companies that surpassed forecasts as failed to live up to them. Three large companies with very weak reports accounted for the entire divergence from forecasts at aggregate level.

Although first quarter earnings were disappointing, analysts have hardly changed their full-year forecasts at all. This is because many reports mentioned important bright spots: Europe is bouncing back. After a long period of weak demand in the region, nearly all listed companies join a chorus of praise about discernible signs of improvement.

A promising earnings engine

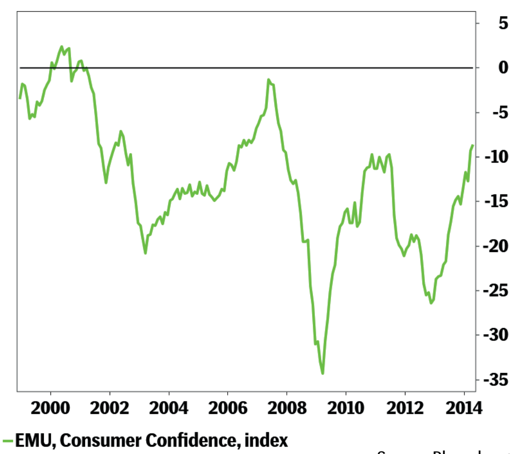
Other European countries remain the biggest market for many listed Nordic industrial and service companies. Although the relative role of the European market has been steadily declining over the past decade due to increased exposure to Asia and other emerging regions in particular – but also due to the faster recovery of recent years in North America – Europe is still important. Aside from direct exposure, there are often dynamic effects (such as the dependence of earnings on the economic situation in Europe) which are greater than indicated by the proportion of direct sales to Europe.

Slightly better growth elsewhere in Europe may have a big impact on the profitability of many large listed companies in the Nordic region and play a key role in achieving the earnings growth we are forecasting: 9 per cent in 2014 and 15 per cent in 2015. Such earnings growth would enable earnings to catch up with generous share valuations. Higher earnings are also critical if we are to adopt a more positive long-term view of the stock market.

Consumer confidence stronger throughout Europe

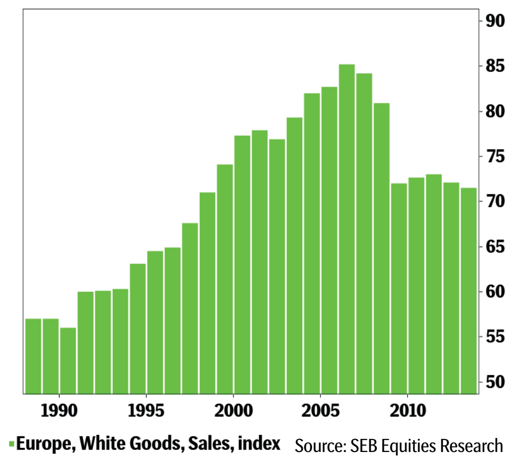
Consumer confidence is now gaining strength throughout Europe, especially in the euro zone. It is not only in Germany that consumers have become more optimistic. Even in Spain and Italy, surveys point to a sharp improvement despite continued high unemployment. Indicators are sensing change, and change is the important thing for listed company earnings. Firms have already adjusted their production and costs to a low absolute sales level. During the difficult years after the Lehman Brothers crash and the euro crisis, households and businesses in Europe postponed all types of investments and purchases. For example, over a period of years home appliance sales have fallen below the level needed to replace old appliances that wear out. Over the past seven years, the market has shrunk by one seventh. Despite tough cost-cutting, manufacturers have basically been unable to generate any earnings at all in the region. Quarterly reports also frequently mention that activity in the European construction sector has improved. New car sales are also showing clear improvement from very low levels.

CONSUMERS SHOWING SPRING FEVER



The chart shows consumer confidence indices in the euro zone. After a strong recovery over the past year, households now seem less worried about the economic outlook than at any time since 2007. This bodes well for sales of listed companies in Europe.

A WARM-UP AFTER SEVEN YEARS IN THE FREEZER



The chart shows the total home appliance market in Europe in millions of units per year since 1988. The latest economic slowdown in Europe has been the longest and deepest in modern times.

Trump card for the stock market

Signs of recovery in Europe offer hope that after two years of shrinking earnings, listed companies will once again start to show positive earnings growth. But above all, a completely different factor is providing support to the stock market: the same driving force that is behind the strong stock market rally of recent years. Extraordinarily stimulative monetary policies by central banks are keeping interest rates and bond yields low, and liquidity in the financial system is very good. In their search for returns, many investors thus find equities the least bad alternative, despite high valuations in a recent historical perspective. We see capital rapidly flowing into stock markets as soon as any kind of storm clouds lead to a downward price correction, and equity indices quickly recover after each dip.

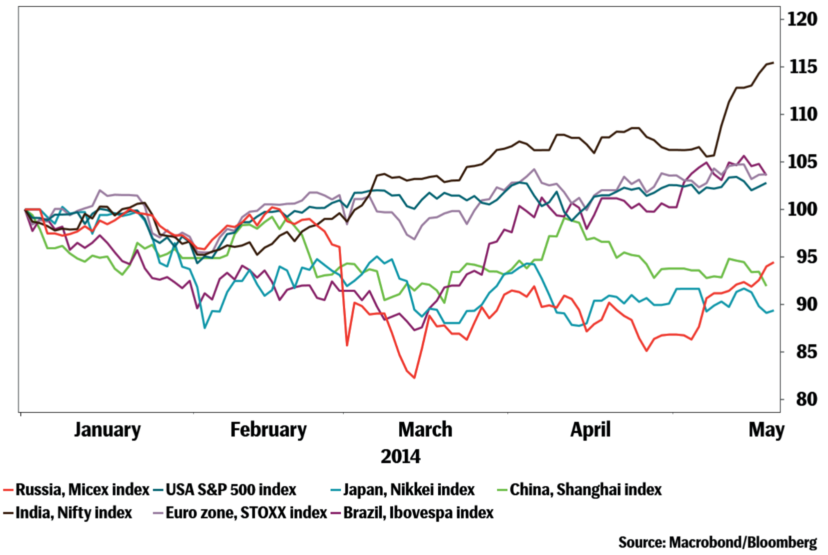
Our view of the stock market

Overall, we have a neutral view of the stock market, since monetary policy and low interest rates and yields are providing good support while high share valuations and mediocre earnings growth are limiting the upside. However, economic developments around Europe are generating hopes that when we eventually leave the current deadlock between weak earnings growth and low/falling return requirements, earnings may gain the upper hand.

Hope for earnings as economy rebounds

- **Sideways market movements in the first quarter**
  After prices fell in January, the global stock market bounced back in February, followed by small price increases in March and April. India and Brazil had a good start to the year and top the statistics along with European equities, while Japan and Russia have struggled.
- **Growth stocks fell on a broad front**
  An unexpected trend shift and a powerful sector rotation occurred at the end of March. Investors took profits in growth companies and instead bought under-priced value shares. America's tech- and biotech-heavy Nasdaq stock exchange fell sharply.
- **Equities look like a good investment if earnings take off**
  Stable macroeconomic data in the first quarter are pointing in the right direction. Looking a bit further ahead, a brighter economic outlook and global growth will have an impact on corporate earnings. Equities will then probably be supported by upward earnings adjustments and better expected returns than other asset classes.

GEOGRAPHIC BREADTH AMONG TOP-PERFORMING STOCK MARKETS



The Indian stock market has been by far the best performer, but Brazil (magenta), the euro zone (lavender) and the broad S&P 500 index in the US (dark blue) have gained ground so far this year. Russia (orange), China (green) and Japan (turquoise) are at the bottom of the table. Uncertainty about continued restructuring caused profit-taking in Japanese shares, while political turmoil in Ukraine led to a stock market dip in Russia. The world index rose 1.4 per cent in local currencies.

THE YEAR BEGAN WITH FALLING PRICES on the world's stock exchanges. There was a broad downturn in January, with Japan, Brazil and Hong Kong at the bottom. Renewed concerns about emerging markets scared investors after hesitant figures from Chinese purchasing managers. The market then bounced back unexpectedly fast, supported by stable US macro data. March and April offered modest price increases. The world index has risen 1.4 per cent in local currencies and 4 percent in SEK since January 1. Emerging markets have performed well overall, driven only by the stock exchanges in India and Brazil, while Chinese and Russian companies have lost value. The Indian market rose in the run-up to the parliamentary election, amid hopes of economic reforms. Japan and Russia have performed the worst this year. In Japan we saw profit-taking in the first quarter, since the consumption tax hike on April 1 caused uncertainty about the economic recovery in general and consumption in particular.

Trend shift in the stock market?

Global stock market performance initially followed the same sectoral trends that we have seen over a long period. Growth companies in information technology (IT) and pharmaceuticals and typical quality companies outperformed the overall market. In late March, however, a powerful sector rotation occurred. Investors took profits in growth companies and instead bought under-priced value shares. America's tech- and biotech-heavy Nasdaq exchange lost value. But it is too early to tell if we are seeing a trend shift or if this is a good time to buy quality shares at lower prices. Worth noting is that IT companies continue to deliver better earnings growth than the overall market, suggesting continued price potential. We are also seeing good growth in cyclical sectors such as industrials, materials and consumer discretionary. Globally, valuations are showing no major differences at present. Nothing stands out as being extremely attractive or overvalued. Financial sector companies are valued at a little lower than average, while consumer and pharmaceutical shares are more expensive – following the historical pattern.

Earnings have been adjusted downward

We expect overall company earnings to grow by 9 per cent this year and 11 per cent in 2015. Earnings have been adjusted slightly downward since February, when 10 per cent growth in 2014 was projected. Global equities are valued at a price/earnings ratio of 15 in 2014, or above historical averages. High valuations, combined with a lack of upside surprises in company reports, make us a little cautious about the stock market in the short term. US equities seem the most expensive, with a P/E ratio of over 16, while stock markets in Europe and Japan look cheaper. We are thus overweighting European companies in our portfolios. Emerging markets, especially in Asia, are still the cheapest; China and Russia stand out, with some of the lowest P/E ratios globally. But investors should be careful about Russia, since companies there are grappling with shrinking earnings. Chinese corporate earnings, on the other hand, are predicted to grow by 10 per cent this year and 11.5 per cent next year.

Strategically positive

World stock markets have remained flat for some time in anticipation of better earnings growth, which would enable P/E ratios to increase. The Ukraine conflict and questions about China's long-term growth has made investors hesitant. But first quarter macro data pointed in the right direction. Eventually a brighter economic outlook and global growth will have an impact on corporate earnings. Equities will probably also be sustained by better expected returns than other asset classes. This year will probably be another good one for global equities, even if we have to wait until autumn to see lasting price increases.

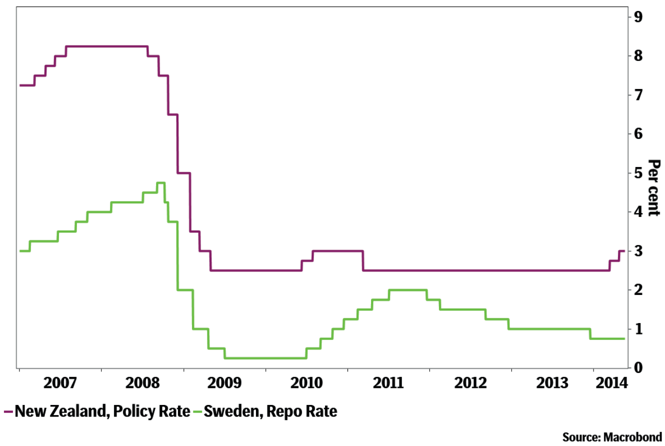
REGION	WEIGHT*	REASONING
Globally	1 2 3 4 **5** 6 7	Global share valuations are high by historical standards, limiting their short-term potential. Looking further ahead, global equities will enjoy continued support from economic growth. Higher P/E ratios and share prices will require upward revisions in earnings forecasts and better earnings performance. Stable macro data bode well for future corporate earnings.
Europe	1 2 3 4 **5** 6 7	We are overweighting Europe in our portfolios, since economic statistics are showing stable and continuous improvement. Valuations and earnings growth look attractive compared to the US and emerging market (EM) countries. The European Central Bank and fiscal policies are supportive, and companies are cost-effective and competitive.
US	1 2 **3** 4 5 6 7	Macro data are continuing to improve, but good earnings growth and slimmed-down companies have already provided a strong market for a long time. Valuations are high, which limits potential.
Asia/EM	1 2 3 **4** 5 6 7	Asia continues to be a growth investment for the long term, but some caution should be exercised at this time. Due to unstable forecasts and uncertainty about policy decisions, we are tactically reducing the weighting somewhat in our portfolios. Choose less developed countries in Asia with high growth potential. Avoid pure commodity exporters.
Japan	1 2 3 **4** 5 6 7	The government's stimulus package triggered a stock market rally and a fall in the yen. Earnings estimates are high and earnings are being adjusted upward, but from low levels. Stimulus measures are having a positive effect on Asia as a whole. There is some uncertainty as to whether these measures will be successfully implemented in their entirety.

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

Fixed income market soon to be reshaped

- **Divergent monetary policy paths in the US and Europe**
  While the US Federal Reserve is likely to end its bond purchase programme in the autumn, the European Central Bank is poised to launch its own, and Sweden's Riksbank will probably lower its key interest rate in July. Deflation worries in Europe, but not in the US, are an important reason for the different paths.
- **We predict rising government bond yields in developed markets**
  In early 2014, government bond yields fell on both sides of the Atlantic when the economy delivered downside surprises and risk appetite waned due to the Ukraine crisis. However, given our forecast of gradually higher growth in the global economy and easing geopolitical tensions, government bond yields in developed markets are likely to move higher over the next couple of years.
- **The heyday of corporate bonds is now behind us**
  Since early 2009, corporate bonds, especially high yield, have given fixed income investors a tremendous ride – even taking into account their drop in value during the third quarter of 2011 – and conditions are still favourable. All the same, the rapidly shrinking yield (or credit) spread to government bonds means that the heyday of corporate bonds is now behind us.

IN DIFFERENT KEY INTEREST RATE WORLDS



While the Reserve Bank of New Zealand (RBNZ) raised its key interest rate twice during the spring (magenta), Sweden's Riksbank has left its key rate (green) unchanged after lowering it in December. The RBNZ will probably raise its rate again this summer, since the country is experiencing high economic growth and inflation risks. Meanwhile, the Riksbank – given Sweden's deflation risks – will very likely lower its rate in July, and perhaps one more time in the autumn.

MOST SEGMENTS OF THE GLOBAL fixed income market generated good returns during the first four months of 2014. European government bonds in particular offered upside surprises. The factors generally paving the way for lower yields/higher bond prices were

1) a preponderance of downside economic surprises early in the year for both developed market (DM) and emerging market (EM) countries,
2) persistent very low inflation/deflation worries in some DM countries and
3) waning risk appetite because of geopolitical drama, with Russia and Ukraine playing the leads, which increased the demand for "safe" government securities.

During these months, prices of European government bonds climbed far more than those of their US counterparts. This was largely due to a sharp decline in government bond yields for the GIIPS countries (Greece, Ireland, Italy, Portugal and Spain) as a result of strong demand by global fixed income investors – reflecting their search for yields – but also of greater deflation risks in Europe compared to the US. Anyone who chose/dared to buy a basket of Spanish sovereign bonds at the turn of the year could delight in a return of a full 7 per cent (in EUR) by the end of April.

Investors who opted for high yield (HY) US corporate bonds during the same period saw greater growth than those holding US Treasuries, while European HY outperformed government bonds in the core euro zone countries, such as Germany. So far this year, EM debt has had the bumpiest ride, with lower returns for January-April than GIIPS bonds and HY.

The key factors in this bond investment value growth are the direction of interest rates/yields and what is happening with the yield (or credit) spread between corporate and government bonds. So far this year, government bond yields on both sides of the Atlantic have fallen, whereas the spread to HY has narrowed. The smaller spread means that corporate bond yields have fallen/prices have risen more than for government bonds. This is illustrated by an investment in the US HY market, which generated a 3.5 per cent return compared to 2 per cent for US government bonds during the period January-April (measured in USD).

Our crystal ball indicates improving economic conditions in the DM countries, led by the US. Combined with prospects of slightly higher US inflation over the next couple of years, this is causing the Federal Reserve to gradually taper its bond purchases. Our forecast is that the Fed will launch a cycle of interest rate hikes next summer. This suggests rising US government bond yields over the next few years.

In parts of Europe, conditions are quite different. Although growth will gradually accelerate, at a far weaker pace than in the US, there are deflation risks in some countries. The European Central Bank (ECB) and Sweden's Riksbank are both concerned about this. So we predict that the ECB will launch a major bond purchase programme and the Riksbank will lower its key interest rate. But since these measures have largely been factored into prices already, government bond yields in the euro zone and Sweden will not fall by much in the short term. In the autumn and in 2015 they will join US yields in the journey upwards.

In many respects, the situation in the corporate bond market is still favourable – corporate health is good, there is a low percentage of bankruptcies, economic prospects are fairly bright, and central bank stimulative policies are still in place – but spreads between corporate and government bonds have narrowed greatly and are approaching pre-crisis 2007 levels. So there is less room for further price gains, and the heyday of both HY and investment grade bonds in this interest rate cycle is now behind us.

Due to high running yields on EM debt after rising interest rates during some periods of last year, this asset class may seem attractive. However, uncertainty about economic prospects in some EM countries and the risk that EM currencies (which appreciated sharply last winter) could see another downward correction call for caution in the short term.

ASSET CLASS	WEIGHT*	EXPECTED RETURN NEXT 12 MONTHS		RISK	
		SEK	EUR	SEK	EUR
Treasury bills	1 **2** 3 4 5 6 7	0.6%	0.1%	0.1%	0.3%
Government bonds	**1** 2 3 4 5 6 7	-1.1%	-0.8%	4.9%	4.8%
Investment grade corporate bonds	**1** 2 3 4 5 6 7	1.4%	0.9%	2.5%	2.5%
High yield corporate bonds	1 2 **3** 4 5 6 7	4.1%	3.6%	5.2%	5.2%
Emerging market debt	1 **2** 3 4 5 6 7	6.8%	6.8%	9.4%	9.4%

Source: SEB

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

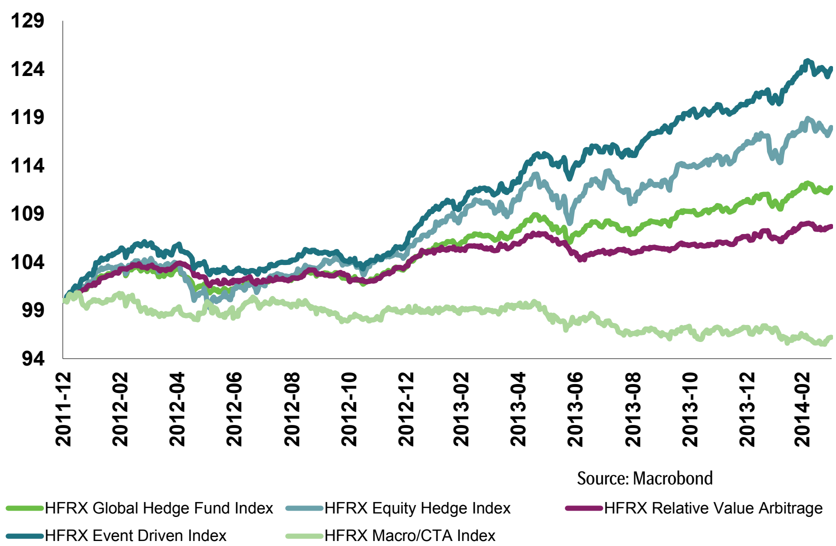
Fundamental value strategies paying off

- **Fundamental value strategies continue to generate yields**
  The markets continued to "normalise" in 2013, with less impact from political actions and more focus on company fundamentals. Equity Long/Short and Relative Value fund managers with fundamental value-driven strategies have generated good returns over the past 12 months, and we expect they will continue to do so.

- **Corporate deals benefit Event Driven strategies**
  Companies are having a hard time growing organically and are carrying out spin-offs and acquisitions, which benefits Event Driven strategies. The continued restructuring of the European banking sector is also creating opportunities for these asset managers.

- **We are beginning to see the light for trend-following strategies**
  Trend-following strategies have had a tough year, with just a few deals determining the bulk of returns. Less "risk-on/risk-off" behaviour is good for CTA strategies, but the still rapid trend reversals mean we are maintaining a cautious approach to Macro/CTA.

EVENT DRIVEN CONTINUES TO GENERATE GOOD RETURNS



With February providing the biggest return, the HFRX Global Hedge Fund Index was up 1.11 per cent during the first quarter. The winning sub-index in this asset class was HFRX Event Driven, with a gain of 2.8 per cent, and the loser was HFRX Macro/CTA, with a decline of 1.04 per cent. The HFRX Equity Hedge Index rose 1.3 per cent, despite two negative months during the quarter, quite closely reflecting the MSCI World Index in USD, which was up 1.4 per cent.

Equity Long/Short

In many ways, the underlying market determines the performance of this strategy. Prior to the first quarter, better conditions were forecast for developed markets than for emerging markets, which was proved to be the case. Strategies that focused on Europe and the US gained about 3 per cent during the quarter, while emerging markets, for instance those focusing on Eastern Europe and Russia, lost about 10 per cent. The theory that beta plays a large role in the performance of Equity Long/Short funds proved true on a broad front, since their performance kept pace with the world index.

More alpha-oriented Market Neutral funds were better performers, up just over 2 per cent. However, this strategy had a tougher time in March, when there was a clear trend shift in the market from growth equities (such as IT and biotech) to more value-oriented equities. Looking ahead, we foresee a second half of the year with stronger risk appetite after a lengthy period of consolidation. The fundamentals are more or less unchanged, with a slow economic recovery, continued central bank support and stabilising emerging market (EM) currencies. This points to good investor appetite for equities in these countries; for instance, in the last two weeks of March, the Brazilian stock market rose 11.5 per cent in local currency and 18 per cent in EUR without any significant improvements in economic fundamentals.

With a little patience, investors should realise acceptable risk-adjusted returns in this low interest rate environment, both with Equity Long/Short and Market Neutral strategies.

Relative Value Arbitrage

This strategy ended the first quarter with a gain of almost 1 per cent. The trend was quite similar to that for the Equity Long/Short strategy during the quarter, although the gain was far more limited. While there is some lingering threat of sharply rising interest rates, fears have eased. Central banks are keeping interest rates down and are cautious about ending stimulus measures before labour markets and inflation expectations strengthen considerably. The immediate danger instead is in very small credit spreads between government and corporate bond yields. Since a great deal of capital belonging to private investors is allocated to corporate bonds in the high yield segment, there is a considerable risk of rapid, massive outflows. We therefore believe it is wise to reallocate some of these assets to Credit Long/Short funds.

Return levels will be somewhat lower in 2014, but still high enough relative to the risk-free interest rate.

Event Driven

As noted in the introduction, the Event Driven strategy was a winner during the first quarter, with a gain of 2.82 per cent. We have had a positive view of this strategy for a fairly long time, and our arguments still hold, now perhaps even more so. Corporate acquisition and merger activity is surging, especially in the US and Europe. The US accounts for about 45 per cent of global deals, but in Europe such activity has also begun in earnest. Merger & Arbitrage managers deal with more complex situations, with complexity in itself providing higher potential returns. These managers are very talented; we have seen many signs of this. Companies still have large cash holdings, and there are good funding opportunities. Corporate executives are increasingly comfortable as the economy recovers, and the risk of a euro collapse has more or less been eliminated.

The Event Driven strategy was a winner in 2013 and has clear potential to be one in 2014 as well.

Macro /CTA

This strategy ended the first quarter down a little more than one per cent, posting negative figures for all three months. The last quarter of 2013, driven by mature markets and less risk on/risk off behaviour, led us to believe there was better potential in 2014 (although we expressed a certain scepticism). There has been a clear lack of strong trends, but it is obviously easy to see some in hindsight. Nonetheless, these trends have been too volatile to provide the necessary stability for trend following strategies to be successful. Geopolitics, central bank actions and political statements have continued to have a negative impact on Macro strategies. Sector rotation to value equities and movements between emerging and developed markets have also played a role, while we saw significant currency movements.

It can be argued that this strategy has a diversification value from a portfolio perspective, but we remain sceptical.

STRATEGY	INDEX	PERFORMANCE % (USD)				
		Q1 2014	2013	2012	2011	2010
Global Hedge	HFRX Global Hedge Fund	1.1	6.7	3.5	-8.9	5.2
Equity Hedge	HFRX Equity Hedge	1.3	11.1	4.8	-19.1	8.9
Relative Value	HFRX Relative Value Arbitrage	0.9	3.0	3.6	-4.0	7.7
Event Driven	HFRX Event Driven	2.8	13.9	6.0	-4.9	2.0
Macro	HFRX Macro	-1.0	-1.8	-1.0	-4.9	-1.7

Source: Bloomberg and SEB

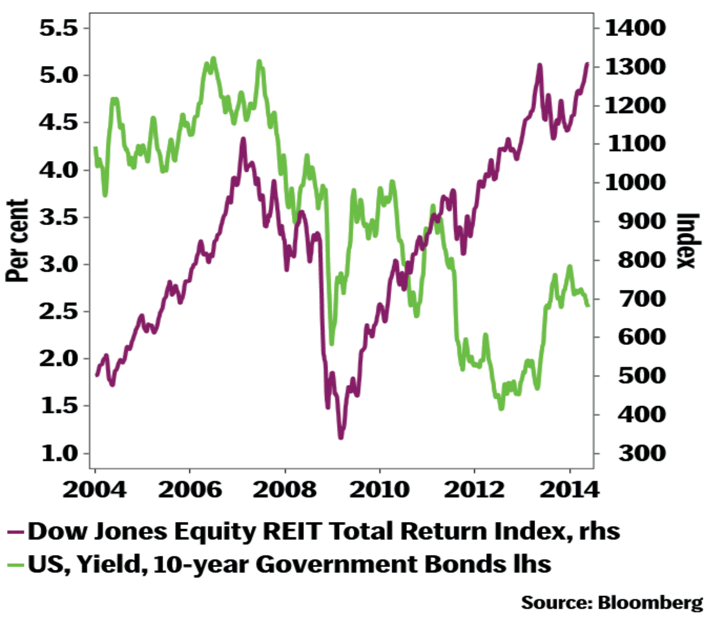
Better fundamentals ease interest rate worries

- **Economic recovery provides better climate for property investments**
  Leading indicators in both Europe and the US are signalling some stability in the economic recovery. The US Federal Reserve is reducing its monthly bond purchases and is expected to raise its key interest rate before the European Central Bank does.

- **More than yield fluctuations behind favourable REIT market**
  Last year, rising long-term yields led to increased volatility in the real estate investment trust (REIT) market. During the first quarter of 2014, long-term yields fell in both Europe and the US, but the positive trend for REITs also seems to be largely driven by better economic fundamentals.

- **The number of direct investments in commercial properties continues to rise**
  Direct investments in commercial properties increased sharply during the first quarter in both Europe and the US, while uncertain growth prospects in Asia contributed to a decline in direct investments during the same period.

US REIT MARKET AT PEAK LEVELS



Between 2004 and 2007, prices of US REITs rose while yields on US 10-year Treasury notes rose. Prices in the REIT market today are sharply higher than before the financial crisis of 2008-2009.

IN THE LAST ISSUE of *Investment Outlook* (published in March 2014) we wrote about the increased interest rate sensitivity of listed property markets. At the same time, we saw improvements in economic fundamentals both in Europe and the US, while transaction volume in a number of Asian markets reached new highs last year.

The economic recovery continues and has recently been bolstered by a number of positive macroeconomic signals in Europe and the US. In the US, labour market data and consumer confidence have both exceeded market expectations, giving a green light to the US central bank, the Federal Reserve, to continue tapering its monthly bond purchases and probably raise its key interest rate next summer. In contrast, further stimulus measures and continued low key interest rates are expected in Europe..The REIT market has turned in a strong performance so far this year. The US REIT market, as measured by the Dow Jones REIT Total Return Index, has generated a return this year of almost 14 per cent calculated in SEK. In Europe the FTSE EPRA/NAREIT Developed Europe Index has shown a return of just over 11 per cent in SEK. In Asia, the EPRA/NAREIT Asia REIT Index is up almost 10 per cent in SEK.

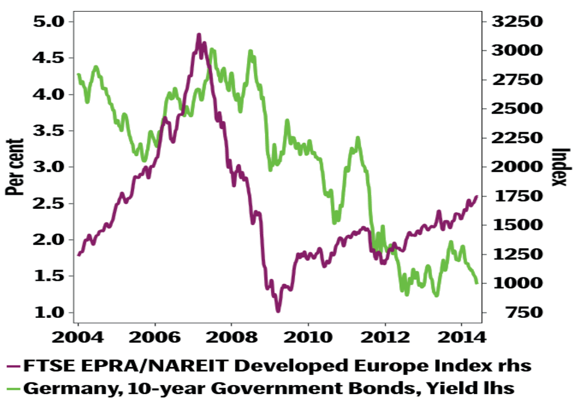
Despite a strong start to the year, many REITs are trading at discounts to net asset value (NAV). According to the Fitch credit rating agency, the average discount to NAV in late April was just over 7 per cent. Combined with falling return levels mainly in primary markets, this has made share repurchases appear attractive. According to the National Association of Real Estate Investment Trusts (NAREIT), the rating agency is warning that share repurchases could certainly improve NAV in the short term, but in the long term they may lead to increased debt and thus a lower credit rating.

Globally, direct investments in commercial properties were up 26 per cent in USD (according to Jones Lang Lasalle) during the first quarter compared to the same period last year. The largest contributor to this increase was the US, while such investments in Asia fell 15 per cent during the same period. Declining interest in Asia is due largely to increasingly uncertain growth prospects in many markets as well as an apparently fragile Chinese financial sector. In the list of cities with the biggest direct investments in commercial properties during the first quarter, Stockholm ranked 13th, the only Nordic city in the top 20. Also worth noting is that neither Hong Kong nor Singapore made the top 20 list, due to government interventions aimed at cooling their property markets. Globally, Stockholm is considered a secondary market compared to cities such as London, New York, Tokyo and Paris. One trend described previously is that ever higher prices are bringing down yields in primary markets, gradually causing investors to move further out on the risk scale in the search for returns. According to Jones Lang Lasalle's second quarter report, rising transaction volume in secondary markets (such as Stockholm) is a trend that is expected to continue.

In previous issues of *Investment Outlook*, we have discussed the increased interest rate sensitivity of the REIT market. In 2013, earnings in the broad REIT market showed an almost inverse relationship with long-term government bond yields. Real estate investments are often associated with borrowing, which creates dependence on the general interest rate and yield situation. Rising long-term yields indicate expectations of higher yields in the future, which – all other things being equal – increases the interest expense for all types of leveraged investments. As in the bond market, the duration of the contract is crucial to the interest rate/yield sensitivity for this source of returns.

Yields on US 10-year Treasuries have dropped almost 14 per cent since year-end, from just over 3.0 to 2.6 per cent. Their German counterparts have fallen almost 22 per cent during the same period, from just over 1.9 to 1.5 per cent. The previous negative correlation between the fixed income market and the REIT market is not as evident this year. In the US, yields on 10-year Treasuries fell sharply in January and have fluctuated since then in the 2.6 to 2.8 per cent range. Meanwhile, the US REIT Index has gradually climbed, although with some volatility. Better economic fundamentals, together with volatile long-term yields that are trending flat but at a low level, seem to have provided a good market climate for both US and European REITs.

SEB's forecast for yields on 10-year government bonds 12 months from now is 3.25 per cent in the US and 2.05 per cent in Germany. Further monetary stimulus from the European Central Bank to combat low inflation might temper rising yields in Europe, whereas the US Federal Reserve may conceivably raise its key interest rate during the summer of 2015. As fundamentals continue to improve, yields are likely to rise slowly. A stable yield trend with continued improvements in fundamentals suggests that a small position in REITs may be an attractive investment in a portfolio designed for greater risk-taking.



Source: Bloomberg

EUROPEAN REIT MARKET IS FAR FROM PRE-CRISIS PEAK

European REIT prices, like US REIT prices, rose earlier in tandem with rising long-term yields. In Europe, prices are slightly more than half their levels before the crisis of 2008-2009.

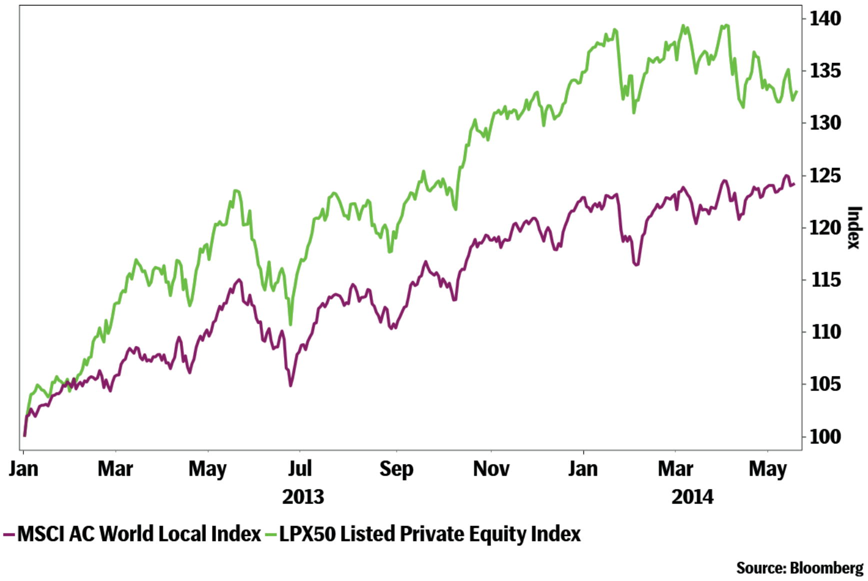
Major assets remain to be sold

- **Listed private equity more like the stock market**
  In the past year, growing risk appetite has contributed to a lower beta for listed private equity versus the stock market as a whole, than we have seen over the past decade.

- **Large assets remain to be sold**
  Despite numerous exits last year, statistics indicate that a large number of mature companies remain in private equity funds. If the relatively risk-friendly climate holds, such assets will continue to be divested.

- **Increasing transaction volume in the secondary market**
  A growing number of portfolio companies are being sold to other private equity investors while the share of initial public offerings (IPOs) backed by private equity companies during the first quarter was at a historical low.

FLAT MARKET AFTER A STRONG 2013



Growing risk appetite benefited listed private equity last year. Performance during the first quarter of this year was in line with the stock market as a whole, which trended flat.

IN THE LAST ISSUE OF *Investment Outlook* (published in March 2014), we described how low market volatility has created opportunities for private equity (PE) as an asset class. The stimulative monetary policy of leading central banks has increased general risk appetite and contributed to stable price multiples, which in turn have benefited the exit market. The high transaction activity last year continued into the first quarter, confirmed by a number of large bids and acquisition rumours both in Europe and the US. The price trend for listed PE so far has not been as strong as the transaction market, but it has not been more volatile relative to the global stock market either.

Last year was generally good for risk assets, and listed private equity was among the winners, measured by the LPX50 Total Return Index. Over the past ten years, listed private equity (LPX50 Total Return Index) has had a beta against the MSCI World AC Index in local currency of 1.4. As volatility declined, beta fell to 1.05 in 2013. Despite a slight increase in volatility early this year, the trend for listed private equity is in line with the broad global index (that is, close to 1). Given the historically high beta, a more volatile price trend for listed PE could have been expected.

Flat market during the first quarter

Growing risk appetite benefited listed private equity last year. Performance during the first quarter of this year was in line with the stock market as a whole, which trended flat.

Last year was a good year for the transaction market. Initial public offerings (IPOs) rose in both volume and number. Many private equity firms chose to sell their mature holdings after a lengthy period of market turmoil, but also as a result of management companies wanting to realise gains for their owners. The number of transactions in the private equity market gradually increased last year but has fallen slightly this year. In a CNN Money study of 7,500 US companies owned by private equity funds, just over 50 per cent had been owned for more than six years. If the relatively good risk climate holds, with consequent activity in the transaction market, there is good potential to realise gains generated via both public and private market players.

Many firms have large cash holdings, mainly due to the relatively limited number of new investments, together with high exit activity and continued large inflows to funds. If the sale of mature investments continues, these cash holdings are resources that will keep prices up in the secondary market.

Transaction activity between private equity firms over the past year has reached historically high levels. During the first quarter of 2014, preliminary data from CNN Money show that 45 per cent of all private equity exits were transactions between private equity funds. During the golden years 2005-2007, the corresponding figure was 36 per cent. At the same time, the percentage of IPOs backed by private equity companies was at a historical low. Given the large inflows of new capital to private equity funds, it is not unlikely that this is the beginning of a new trend. New capital has to generate yields in a market with a growing number of mature portfolio companies. The high valuations of publicly traded companies are also reflected in private equity transactions, with few publicly held companies being bought and delisted.

However, increased volatility would probably limit activity in the transaction markets. Increased tensions in the Ukraine conflict, growth concerns in Asia, deflation worries in Europe and rapidly rising government bond yields in the US are risk factors that could trigger increased volatility.

If economic growth in Europe and the US continues without being disrupted by the above risk factors, there is good potential for the private equity asset class. In a portfolio with a long investment horizon, it may be advantageous to allocate a portion of stock market holdings to listed private equity.

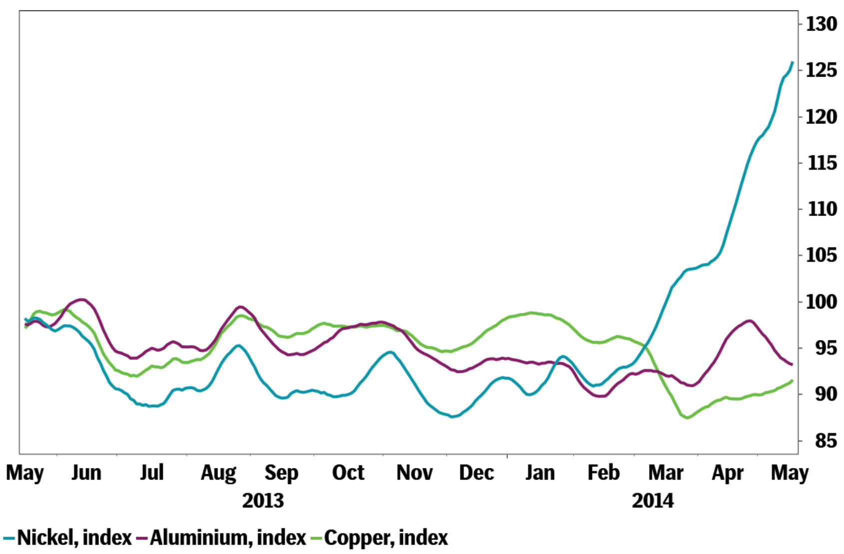
Extraordinary events impact commodity prices

- **Geopolitical drama behind rising prices**
  The current situation in Russia/Ukraine is behind unexpectedly sharp price rises for palladium, wheat and maize (corn). In our view, most of the effects of this turmoil are now factored into current prices. The upside, while it certainly exists, has diminished.

- **South African miners' strikes continue**
  Mining companies were prepared, but we are now nearing the pain threshold after protracted strikes in South Africa. Both platinum and palladium are produced to a large extent in the country, and continued price rises are likely.

- **Indonesia's export ban had a strong impact**
  This spring we have seen a variety of price trends for industrial metals. Indonesia's ban on nickel ore exports finally had a substantial impact, but we are now probably nearing the end of the sharp increase in prices.

DRAMATIC PRICE CHANGE FOR PRECIOUS METALS IN MARCH



Source: Bloomberg

While awaiting stronger economic conditions and a more stable China, metal prices have generally trended flat over the past year. Indonesia's export ban on nickel ore, implemented early in the year, changed this picture dramatically, though with a lag of about one month. The country accounts for some 20 per cent of global nickel ore production, so the impact on prices globally is not remarkable.

THE OIL PRICE TREND HAS BEEN RELATIVELY uneventful over the past year. We are sticking to our assessment that global oil production will increase by 2 million barrels/day in 2014, while demand will rise by 1.3 million, and the Organisation of the Oil Exporting Countries or OPEC (mainly Saudi Arabia) will continue to adjust production. Prices slightly above our forecast during the second quarter were due to unexpectedly low supply from Libya. Oil exports from that country last year were 700,000 barrels/day. Now, because of falling production in the western part of the country, they are just over 200,000 barrels/day (capacity 1.5 million barrels/day). We expect **oil** to trade at around USD 105 at year-end as well. Full exports from Libya and Iran would increase supply by around 2 million barrels/day. We consider this development unlikely; however, if that were the case, Saudi Arabia would probably refuse to adjust its own supply downward, but instead force the other OPEC members to the negotiating table (most likely by letting oil prices fall).

Overall metal prices have fallen somewhat since the beginning of the year, but the trend varies significantly. A sharp rise in **nickel** prices stands out. Indonesia, whose nickel ore production accounts for about 20 per cent of the global total, imposed an export ban on nickel ore early this year. This did not initially affect prices, since on previous occasions the country did not implement what it had promised, so its credibility was low. However, this time Indonesia went from word to deed and implemented the ban, with prices rising as a result. The current Russia/Ukraine situation has further fuelled the price rise, since Russia is a major nickel producer (third largest in the world), although the country's exports have not yet been affected.

Copper prices have been weak this year. Larger increases in supply than in demand, combined with continued worries about China's economic growth, have weighed heavily.

The **aluminium** market is in balance, but inventories are still high. In our view, both copper and aluminium prices will be slightly higher by year-end, while nickel prices will probably be around current levels.

After eleven years and almost a 600 per cent price increase, **gold** began to fall in 2012. Minimal inflation expectations, no need to "flee to safety" and a decline in speculative activity were behind the trend. We expected a further fall in early 2014, especially since the outstanding volume of exchange-traded funds or ETFs (with physical gold as the underlying asset) remained very high. Escalating tensions in Russia and Ukraine have put an end to falling prices and have potential to change our forecast of a continued price decline.

Almost half of global **palladium** production takes place in Russia, so the price is affected by the prevailing geopolitical situation. Miners' strikes in South Africa have also contributed, since just over a third of global production takes place there. Global inventories have started to fall, and prices have risen relatively sharply.

Although the strikes in South African **platinum** mines (accounting for two thirds of global production) are continuing, platinum prices have not risen significantly. The mining companies were prepared for a protracted strike and had built up large inventories. They probably did not want price increases, since that would have weakened their bargaining position. Inventories will soon be empty, and without a labour agreement, prices should thus rise. Both platinum and palladium are largely used for catalytic converters in automobiles, so increased car sales will also provide support for these precious metals, which we anticipate will see higher prices.

We have long expected falling prices for **agricultural products**. Although most of this expected decline is probably now behind us, in our view prices should fall further. Weather and other unpredictable factors always have the potential to undermine our scenario, as was the case this spring. The drought in Brazil has boosted coffee prices by about 70 per cent so far in 2014, and the situation in Ukraine has resulted in higher prices for both wheat and maize (the country is the fourth largest exporter of maize and sixth largest exporter of wheat).

ASSET CLASS	WEIGHT*	REASONING
Energy	1 **2** 3 4 5 6 7	Oil supply is expected to increase more than demand during 2014. OPEC, mainly Saudi Arabia, will adjust its supply for market balance. Oil prices will be around today's levels a year from now.
Industrial metals	1 2 **3** 4 5 6 7	A balanced market, with potential for marginal price increases during the year. A focus on nickel after Indonesia's ore export ban.
Precious metals	1 **2** 3 4 5 6 7	We believe that a better economic situation and low inflation expectations will continue to weigh down gold prices. South African miners' strikes and tensions between Russia and Ukraine, combined with better car sales, will help sustain higher palladium and platinum prices.
Agricultural	**1** 2 3 4 5 6 7	We believe agricultural prices should fall. Extraordinary events can always change this picture, as the turmoil in Ukraine did this spring.

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

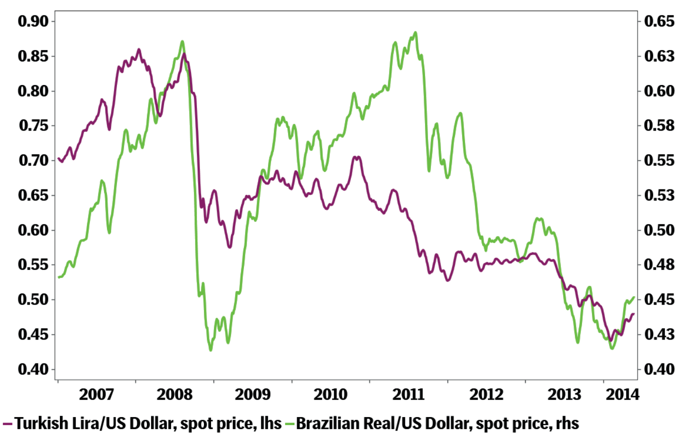
Growth, inflation and rates steer currencies

- **Higher growth and inflation = higher interest rate expectations = stronger currency**
  The currencies that have gained the most value in recent months belong to countries with growing economies and inflation close to target, two factors that have raised expectations of monetary tightening down the road, which will benefit these currencies.

- **Gradually stronger prospects for USD vs. EUR and JPY**
  So far in 2014, an American economy affected by severe winter weather and a down-weighting of the US dollar by global portfolio managers have held the USD down. However, prospects of much faster US growth and a less accommodative monetary policy from the Fed, combined with new stimulus measures from the European Central Bank and the Bank of Japan, point to an appreciating USD.

- **Advantage NOK in 2014, advantage SEK in 2015**
  While the Norwegian central bank has finished cutting its key interest rate, we predict Sweden's Riksbank will lower its own key rate both this summer and autumn due to deflation worries. This will weigh down the SEK. Next year, the balance will then shift in favour of the SEK, when the Riksbank changes direction and starts raising its key rate again, with Swedish growth accelerating as Norwegian growth levels off.

REVERSAL IN STORE AFTER LAST WINTER'S CURRENCY GAINS



Source: Bloomberg

Former Fed Chairman Ben Bernanke's announcement in May 2013 that a tapering of the US central bank's bond purchases was imminent caused emerging market (EM) assets to fall on a broad front. This was followed last winter by a currency rebound in Turkey, Brazil and elsewhere. However, these currencies and others in the EM sphere could fall again. This is because most EM currencies are overvalued, EM growth is still decelerating, there are signs that the central banks of Turkey and Brazil, among others, are about to ease their monetary policies, and US government bond yields are poised to rise after last winter's decline.

SO FAR IN 2014, COUNTRIES that have shown a combination of stronger economic activity and inflation near their central bank target have seen their currencies appreciate. That is because this kind of macroeconomic mix points towards tighter monetary policy (for instance, higher key interest rates) being not too far off. An economic environment of this nature favours commodity currencies such as New Zealand's NZD, Australia's AUD and Norway's NOK (also see below). The New Zealand currency has shown particular strength since the Reserve Bank of New Zealand (RBNZ) began its interest rate hiking cycle in March 2014 (the RBNZ frequently leads the way in this kind of situation).

GBP – could lose some strength

Given the rebounding British economy, the pound (GBP) has shown strength recently as the foreign exchange (FX) market has started to discount hikes in the Bank of England's key interest rate (currently 0.50 per cent) during the coming year. However, inflation in the UK has meanwhile fallen towards the 2 per cent target and could very well stabilise below target going forward. Large trade deficits also indicate that the UK needs a rather weak currency. Bank of England guidance will thus probably lower market expectations of an interest rate hike, causing the GBP to lose some of its current strength.

In recent months, the US dollar (USD) has been unexpectedly weak, weighed down by sluggish US economic data. The factors behind this are an unusually harsh winter, a reduced weighting of the USD in many global managers' asset portfolios and the Ukraine crisis, which has led Russian players to reduce their USD exposure out of fear that their US accounts will be frozen.

Meanwhile, the euro (EUR) has benefited since the turn of the year from continued signs of economic recovery in the euro zone. At the same time, international fixed income managers have purchased EUR in order to invest in government bonds in the GIIPS countries (Greece, Ireland, Italy, Portugal and Spain), which have attracted investors with relatively high running yields.

USD – strengthening against the EUR

However, the economic and monetary outlook point towards the USD strengthening against the EUR later this year and in 2015. Now that winter has released its grip on US growth, a clear upswing is at hand. The Federal Reserve (Fed) will continue to taper its bond purchases and – according to our scenario – will implement its first interest rate hike (from the current 0-0.25 per cent) in the summer of 2015. In the euro zone, the economy will strengthen only modestly, and GIIPS bonds will gradually lose their attractiveness. This summer, the European Central Bank (ECB) will probably launch a major bond purchasing programme, and its key interest rate will remain at 0.25 per cent for an extended period. In other words, the ECB will pursue a completely different monetary policy than the Fed for the next two years, and the EUR should weaken as a result.

JPY – first strengthening, then weakening

After previous large declines following the introduction of Japan's stimulative Abenomics policies, the yen (JPY) has stabilised against the USD and other currencies. The JPY could also appreciate somewhat in the short term due to uncertainty about whether the Bank of Japan (BoJ) will provide further monetary stimulus in response to prevailing signs of an economic reversal in the country. Assuming that the BoJ expands its asset purchases in a few months, the JPY will probably weaken once again.

SEK – weaker due to rate cut expectations

The Swedish krona (SEK) is weighed down by expectations that Sweden's Riksbank will lower its key interest rate in early July. If our forecast – that the Riksbank will then lower the rate one more time – proves correct, then a summer and early autumn marked by a weaker SEK are at hand. The Swedish general election in September could also produce some temporary uncertainty, but towards the end of 2014 and in 2015, arguments for an upturn in the SEK will gain strength. The central bank will have finished cutting interest rates and will raise them during the second half of 2015, the Swedish economy will expand, and the underlying currency flow situation should generally be positive for the SEK.

NOK – limited appreciation expected

As for the Norwegian krone (NOK), the currency has recently appreciated thanks to waning expectations in the FX market that Norway's central bank will cut its key interest rate from the current 1.50 per cent. Instead, there are many indications that Norges Bank will be among the first central banks to switch to a rate hiking cycle. According to our forecast, Norges Bank will begin raising rates early in the spring of 2015, which will bolster the NOK. However, since Norway's global competitiveness is weak, the NOK's upward movement will be clearly limited.