Investment Outlook

Bright autumn outlook for financial markets

PRIVATE BANKING • INVESTMENT STRATEGY

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Bright autumn outlook for financial markets

"A Tale of Two Cities", the classic historical novel by Charles Dickens, begins with the words: "It was the best of times, it was the worst of times." This quotation might have a bearing on the messages from today's stock and bond markets, respectively. The stock market, having climbed for more than five years, is now sending a message of continued optimism – the best of times. Meanwhile in the bond market, yields are falling to historic lows in Europe and sending a much gloomier message – the worst of times. Which message do we believe?

The macroeconomic picture still appears favourable for risky assets, driven by the US economic recovery which – unlike the European recovery – seems to be stable. What we believe is temporarily weak European macro data is probably more of a short-term slump than a reversal. Continued expansionary central bank policies and an influx of liquidity are likely to persist in a number of places, even if the US Federal Reserve ends its stimulative asset purchases this autumn and raises its key interest rate during 2015. Equities are the asset class we prefer, based on a risk/return perspective. A long-term investor has a lot of positive fundamentals to rely on – the best of times.

In the last *Investment Outlook* (published on May 27, 2014) we asked: "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?"

We then discussed whether the valuations of certain assets, especially equities, were stretched. Our conclusion was that risky assets were still attractive, although return expectations needed to become more nuanced by taking high valuations into account, but also in light of historically low interest rates and bond yields.

During the summer months, a lot happened both in the stock market and in the real economy. This period was dominated by geopolitical worries, which had already emerged last spring but intensified during the summer. This is why this issue includes an update of the Eastern European theme article that we presented in May.

Although July was characterised by greater volatility and downward price movements for various assets, there has been a strong rebound. Late in August, for example, the S&P 500 – a broad US equities index – broke through the magic threshold of 2000 for the first time. Market performance since the notorious financial crisis has been impressive. The index has more than doubled since the spring and summer of 2009, and for more than five years we have seen an essentially uninterrupted economic and stock market upturn. Can this journey continue? We discuss some thoughts related to this in one of the theme articles in this issue.

In many ways, Asia's emerging market (EM) economies have experienced an impressive, exciting and dramatic journey over the past 20 years or so. Our second theme article focuses on Asia, excluding that continent's three economic giants: China, India and Japan. Our final theme article deals with an attractive type of asset: emerging market (EM) debt.

I hope you will find this issue of *Investment Outlook* interesting.

SEBASTIAN SIEGL
Global Head of Investment Strategy

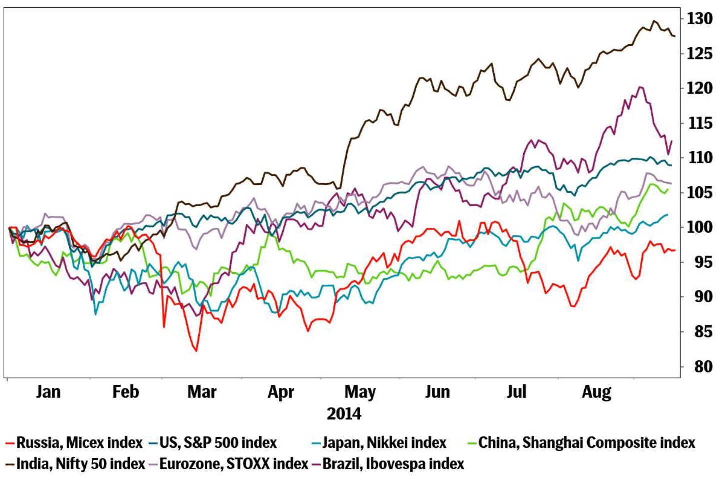
Strong economy will benefit risk assets

The current situation in financial markets includes a significant number of unpredictable and unpleasant global trouble spots, yet stock markets are rising at a decent pace. This confirms the old thesis that markets can live with risks as long as the underlying economy is gaining strength. Another thesis is that the most important economic indicator from a market point of view is that the United States must be stable, which it is today and will probably continue to be.

Today we have a situation where central banks are continuing to pursue stimulative policies. For example, the European Central Bank recently took further steps to stimulate and support the euro zone economy by cutting key interest rates. The consequence of all the support from central banks is that bond yields are extremely low, thus essentially wiping out potential returns in bond markets. In light of this, one should compare expected returns on those asset classes that have similar levels of risk, which justifies investments in hedge funds.

Structurally, we are in an equities phase. We foresee an upturn and stabilisation of the economic outlook during the next six months, which will benefit various types of risk assets, mainly equities. The oversupply in the commodity market after many years of over-investment in emerging markets is keeping prices down. This means that the traditional commodity-driven economic upturn pattern will perhaps not be repeated.

Today the main risk is that market players will expect events to unfold calmly despite the likelihood that one or more of the existing trouble spots will get worse. Another risk is that the measures being undertaken in the euro zone will not take hold and that the region will descend into deflation and stagnation. This is not our main scenario, but it is still deserves some attention.



Source: Bloomberg

STRONG STOCK MARKET PERFORMANCE ON SEVERAL CONTINENTS

The MSCI All Country World Index in local currencies has climbed more than 6 per cent so far in 2014. The Indian stock market is the top performer, driven by hopes of economic reforms. Brazil and the US have also provided good returns. Japan and Russia are at the bottom. Political turmoil in Ukraine is hanging over the Russian stock market, and the Japanese market is waiting to see if Prime Minister Shinzo Abe's structural reforms will actually have an impact on the economy.

TACTICAL EXPECTED RISK AND RETURN

Our risk and return expectations are taken from the SEB House View. These expectations cover the next 12 months and are revised once a month, or more often if the market situation requires.

ASSET TYPE	TACTICAL EXPECTED RISK AND RETURN (YEARLY FIGURES)		COMMENT
	RETURN	RISK	
Equities Global Swedish	 8% 10%	 11% 16.5%	Expected risk and total return for global equities, measured using the MSCI All Country World Index in local currencies. For Sweden, the SIX Return Index is used.
Fixed income Bonds Cash	 3.2% 0.2%	 4.6% 0.1%	The forecast refers to an average duration of 5.5 years (T-bonds 7 years and high yield 4 years). In this case, cash equals assets with risk-free returns, for example T-bills.
Hedge funds	3.5%	3.3%	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	11%	15%	A beta adjustment of global equities, measured as the performance of the LPX50 Total Return and MSCI AC World LOC indices over the past seven years.
Commodities	-1.5%	13%	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 1.27 (-3.5%), EUR/SEK 9.10 (-0.6%) and USD/SEK 7.17 (+3.0%).

MAIN STRATEGIES IN OUR PORTFOLIO MANAGEMENT

- **We are in an equities phase**
  The ongoing stabilisation of the economy and the actions of central banks are steering capital into equities. The US has led this trend, but we believe that other regions (Europe/Asia) will catch up.

- **Bond yields have reached extreme levels – is this sustainable?**
  Central banks have pushed down bond yields by means of key interest rates and quantitative easing. In the long term, this is not sustainable. We should see some adjustment in interest rates and yields, though not to their "old" heights. Government finances and debt remain a challenge, inflation is low and we have a savings surplus, but interest rates and yields will head upward. Meanwhile, it is important to emphasise that central banks will very slowly reduce their stimulus measures and that this will have consequences for the future climate of returns.

- **Market risks will provide opportunities**
  We have a situation where the risk premium on some assets has increased, because of uncertainty about developments. European equities are such an asset, small cap companies are another. Some assets in Asia are being hurt by uncertainty about financing. For those who dare to carry the risk, there are opportunities among these assets.

- **The current business cycle does not include the same commodity patterns as earlier cycles**
  In recent years there has been over-investment in commodity capacity, concurrently with changing consumption patterns in developing countries, away from heavy business investment and towards consumption by an emerging middle class. This means different needs and a new type of demand.

- **In the coming year, global trade should increase**
  Increased global trade is vital to growth. The opportunities for good economic development are biggest in regions with large exports to areas of rapidly rising demand, such as emerging market (EM) countries.

- **Capital spending looks different today from 20 years ago**
  Above we mentioned the commodities issue and changing demand patterns, but there are also more far-reaching consequences. Today a larger proportion of capital spending occurs in technology and services and less in infrastructure, which will benefit new market players.

ASSET	WEIGHT*	REASONING
Equities	1 2 3 4 **5** 6 7	The most important trump card for the stock market is still its relative attractiveness. We are seeing early signs that corporate earnings have bottomed out and are rebounding. We are sticking to our long-term positive view of equities, with a focus on Europe and Asia.
Fixed income	1 **2** 3 4 5 6 7	European government bond yields are record-low, but assuming that inflation expectations in Europe rise in 2015 and that the Fed will then begin hiking key interest rates, government bond yields will climb both in Europe and the US. High yield corporate bonds are again a bit more attractive in the short term after their price slide in July. Emerging market debt offers attractive effective yields but there are currency rate risks.
Hedge funds	1 2 3 **4** 5 6 7	Hedge funds that accept a certain degree of underlying market risk are having a good period. We have been positive towards event-driven strategies for quite a long time, and our reasoning still holds. Corporate merger and acquisition activity is increasing both in the US and Europe.
Real estate	1 2 **3** 4 5 6 7	The real estate investment trust (REIT) market has provided extremely good returns so far in 2014. Fundamental growth and falling government bond yields have contributed to this. Despite a clear negative correlation, rising interest rates and yields need not be a threat as long as economic growth continues.
Private equity	1 2 3 **4** 5 6 7	Looking ahead, government bond yields will rise, but if this occurs concurrently with improved economic growth and increased earnings, there is continued good return potential for private equity.
Commodities	1 **2** 3 4 5 6 7	No sharp price movements are to be expected in the commodities sector, where oversupply is keeping oil prices down. Higher demand for petrol-powered cars, combined with geopolitical turmoil, has pushed up prices for palladium – the precious metal we believe has the biggest potential.
Currencies	1 2 3 **4** 5 6 7	A combination of strong economic conditions and the prospect that the Fed will begin tightening monetary policy in the spring of 2015 gives the US dollar an advantage over the euro and yen. This autumn will bring further SEK weakness, but in 2015-2016 the Swedish currency may recover somewhat.

Source: SEB

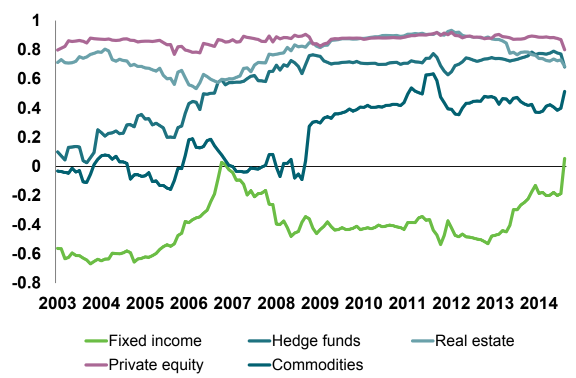
** "Weight" shows how we currently view the asset class as part of a portfolio. Level 4 is a neutral stance. These weights are changed continuously, based on our tactical market view, and may thus diverge from our long-term strategic view of an asset class. At the customer level, portfolios are tailored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

HISTORICAL CORRELATION (SEP 30, 2004 TO AUG 31, 2014)

	Equities	Fixed income	Hedge funds	Real estate	Private equity	Commodities
Equities	1.00					
Fixed income	-0.32	1.00				
Hedge funds	0.70	-0.35	1.00			
Real estate	0.85	-0.11	0.57	1.00		
Private equity	0.87	-0.31	0.70	0.87	1.00	
Commodities	0.35	-0.25	0.67	0.29	0.41	1.00

Source: SEB

ROLLING 36-MONTH CORRELATION VS. MSCI WORLD



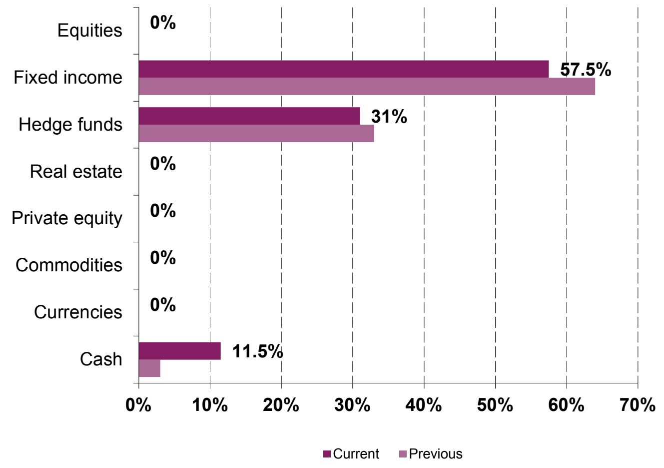
Source: SEB

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

MODERN INVESTMENT PROGRAMMES – ALLOCATION OF CAPITAL AT THREE LEVELS

MODERN PROTECTION

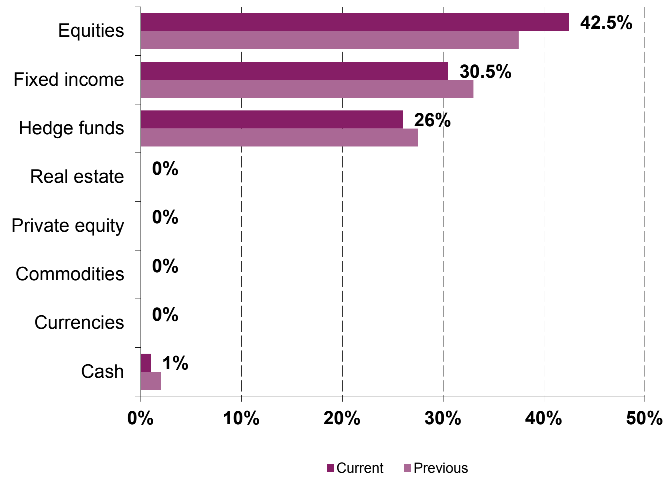
Before the summer, credit (or yield) spreads had greatly shrunk, while divergent government bond yields created difficulties for most absolute return managers. We have not made any changes in the Modern Protection portfolio during the past quarter, while tactically allowing inflows to remain in cash. Practically all credit markets have had a weak summer, undoubtedly affecting Modern Protection. So far in 2014 credit long/short, which accounts for about 17 per cent of the portfolio, has contributed about half of total returns, followed by absolute return (25 per cent), short-term bonds (8 per cent) and senior loans/short duration high yield (11 per cent). We regard this summer's credit market movement as a normalisation of valuations. Looking ahead, corporate bonds should be able to continue their positive trend. In a historical perspective, too, credit markets rarely have negative returns for longer than one quarter. We are now looking into investing our cash.



Source: SEB

MODERN GROWTH

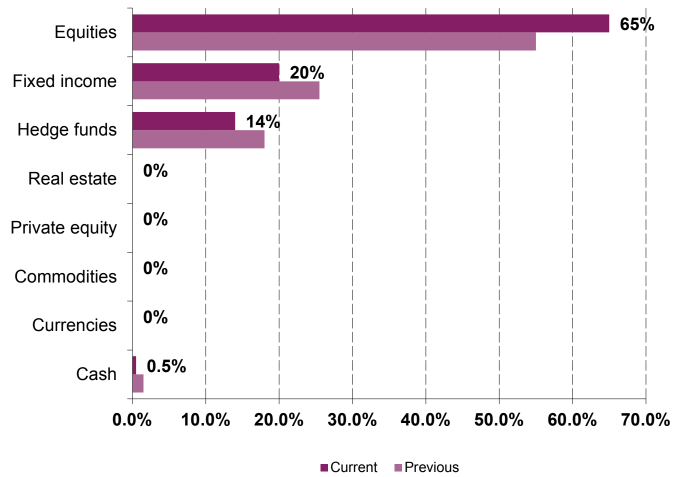
We started the summer with a tactical wait-and-see attitude, considering geopolitical risks and the fact that the summer months tend to be weak, but the macro- and microeconomic picture is that risk assets should benefit from continued economic recovery that will lead to earnings growth and/or liquidity injections by central banks. We thus increased equity holdings from 37 to nearly 43 per cent of the portfolio during the market dips in mid-July and August. We reduced high yield bonds, which looked relatively expensive, as well as hedge funds that had a hard time performing during the spring, each by a couple of per cent. In the fixed-income sub-portfolio the emphasis is on senior loans (11 per cent), short duration high yield (7 per cent), convertible bonds (6 per cent), EM corporate bonds (3 per cent) and contingent convertible bonds (3 per cent). Our basic strategy is to continue increasing risk this autumn, with an eye on both geopolitical and cyclical developments.



Source: SEB

MODERN AGGRESSIVE

In Modern Aggressive, as in Modern Growth, we had a cautious view of stock market risk before the summer but we bought equities during the July and August market dips. Equities exposure now totals 65 per cent, up from 55 per cent earlier. In global equities we mainly increased exposure to Europe, up from 13 to 16 percent of the portfolio. A new component of the equities sub-portfolio is frontier markets (2 per cent); these markets are attractive, with strong economic growth driven by domestic demand growth and are not as dependent on global economic conditions. Our fixed income sub-portfolio no longer includes any high yield bonds, but focuses on senior loans (10 per cent), contingent convertible bonds (3.5 per cent), convertibles (2.5 per cent), EM local debt (2 per cent) and EM corporate bonds (2 per cent). In the hedge fund sub-portfolio we have sold off market neutral (3 per cent) to gain more market exposure, leaving multi-strategy (6.5 per cent), event-driven (3 per cent) and credit long/short (4.5 per cent).



Source: SEB

Sustained stock market and cyclical upturn

The length of cyclical upturns and stock market rallies varies, since the causes of a recession have an effect on the subsequent recovery. This suggests that the current upturn may continue for quite a while.

The cyclical economic upturn now under way in the United States and many other parts of the world began in the summer of 2009, that is, more than 20 quarters ago. Some economists and analysts consider this a long period and are worried that a downturn into recession or a slump will soon be at hand. Others believe history backs their conclusion that the current upturn could continue for quite a while. Which group has the best support for their position?

A look in the macroeconomic rear view mirror, with a focus on the US economy (for which there are good-quality economic history statistics), shows that from the late 1950s to the end of 2007 the US had eight periods characterised by economic upturns. Their average length was 20 quarters, or five years. This also corresponds to the average length of bull markets during the same time span. So anyone worried that the current upturn in the economy and stock market is on its last legs can find historical support for this view.

However, there is great variation in the length of these boom periods. The shortest lasted only three quarters, the longest 35 quarters. Further back in time, booms in the US were often short, which is why the average over the past 150 years is about 14 quarters.

The length of economic and stock market upturn phases has thus varied considerably, which is largely explained by the fact that the causes of a recession/slump have often left their mark on the subsequent recovery.

US economic upswings in the late 1950s and during the booming 1960s were interrupted by traditional cyclical causes. In the early 1960s the cause was a significant shift in companies' inventories from expanding to declining; the late 1960s boom ended as a result of monetary tightening to combat rising inflation in the wake of factors such as the war in Vietnam, which was funded by printing money.

In the early 1970s and at the end of the decade, upswings were aborted when the economy suffered huge oil price shocks. These eroded household purchasing power, increased costs for companies and led to rising interest rates.

The first upturn in the 1980s was interrupted almost immediately by a "double dip" recession when the US Federal Reserve, headed by Paul Volcker, sharply tightened its monetary policy by hiking interest rates and limiting the money supply. The purpose was to bring down the very high inflation then prevailing.

The endings of the next three economic upturns – in the early 1990s, in 2000 and in 2008 – all included elements of burst speculative bubbles. In chronological order, these were 1) the repercussions of the savings and loan crisis and Black Monday on Wall Street in the autumn of 1987, a day that saw the Dow Jones Index fall an incredible 22 per cent; 2) the bursting of the IT/telecom bubble early in the new millennium; and 3) the bursting of the US sub-prime bubble with its unprecedented consequences for the economy and the entire international financial system. After this, we also saw real estate bubbles bursting in a number of European countries, such as Britain, Ireland and Spain.

A look back in time shows that the three US economic booms preceding the one now under way lasted far longer than those from the 1950s to the early 1980s (except in the 1960s; see chart on next page) and came to a halt when speculative bubbles burst. Nor was there any renewed economic setback or "double dip" at the start of these upswing phases.

The current economic recovery, which started in mid-2009, was initially rapid, partly as a reflection of the deep economic downturn preceding it. But since then, the upturn has been long and highly uneven. This bumpy ride has largely been due to recurrent large-scale financial market upheavals in the wake of government financial crises in the GIIPS countries (Greece, Ireland, Italy, Portugal and Spain) from 2010 to 2012. The lowering of the US government's credit rating in the summer of 2011 and Congress's inability to reach budget agreements also triggered bouts of financial turbulence.

Previous economic upswings following burst speculative bubbles were also lengthy. The causes can be found mostly in housing market weakness as a result of large excess supply and tough credit standards. Another explanation is that households and companies have tried to boost their saving and reduce their debt, with weak private consumption and capital spending as a consequence. Finally, improvements in the labour market have been very sluggish, and the resulting uncertain job prospects have also constrained consumption.

Another factor during this upturn phase, dating from the summer of 2009, is heavy pressure for budget austerity in the US and many European countries. But such belt-tightening is now easing, with fiscal policy in the developed market (DM) countries of the Organisation for Economic Cooperation and Development (OECD) now heading into a more neutral phase.

The current upturn (like the three previous ones) has been characterised by plenty of spare production capacity both in terms of labour and real capital (machinery, factories etc.). This has led to low cost/price pressure. The absence of overheating tendencies has paved the way for very low interest rates, which in turn have created a macroeconomic environment that has fostered continued economic growth. Today's historically low key interest rates and government bond yields on both sides of the Atlantic are of course also explained by unprecedented central bank stimulus policies.

Judging from the analysis in SEB's *Nordic Outlook*, published in August 2014, shortages of available production resources, with consequent interest rate hikes, are unlikely to interrupt the current boom during the next few years.

Instead, the duration of the economic upturn will probably be determined by the shape of monetary policy going forward.

The great challenge for central banks will be to devise an exit strategy that avoids an abrupt economic downturn and the development of new financial bubbles. However, this balancing act will probably not be seriously tested until after 2016.

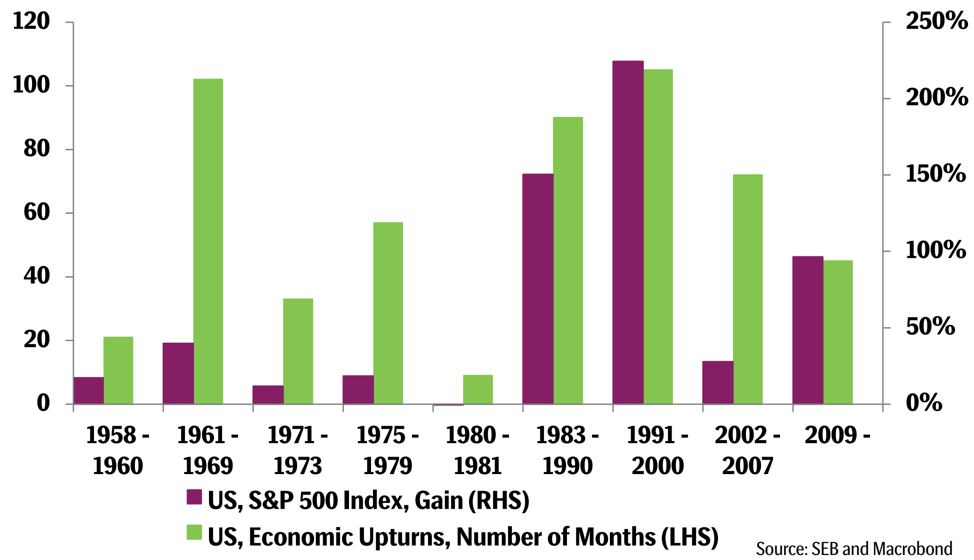
As for what course the bond markets will take, it is important to know what will trigger rising yields in the years ahead. If they are due to the market's faith in stronger economic growth and/or a consequence of less central bank stimulus, then the rise in yields will be categorised as "benign" and not constitute a threat to the economy, at least in the initial phase. However, if increased inflation and inflation expectations are behind the climb in yields, then there is reason to raise a warning flag. The latter case is not our scenario, however.

Another aspect concerning government bond markets is whether the sharp rise in prices and decline in yields – especially in the US, Europe (with yields on German short-term government securities even falling into negative territory) and Japan over the past few years – means that a "financial bubble warning" should be issued. This risk should by no means be dismissed, but since all indications are that central banks have the tools to prevent undesirably large government bond yield increases and price declines, this risk seems very low.

But are there bubble risks in other markets?

There has been lively discussion for some time about whether the Chinese real estate market faces a major price correction, since prices of homes and commercial properties have climbed rapidly in many parts of China. For instance, property prices in Shanghai were up well over 100 per cent during the period 2003-2010. Elsewhere robust construction has led to many empty office buildings and shopping centres – excess capacity that could take decades to absorb.

LONGER CYCLICAL AND STOCK MARKET UPTURNS IN RECENT DECADES



Source: SEB and Macrobond

Compared with earlier post-war decades, in the US both the 1980s and 1990s were dominated by a combination of long economic boom periods and strong stock market performance. The new millennium also began with a lengthy cyclical upturn, but this was accompanied by a weak stock market. The current cyclical and stock market upturn began in the spring and summer of 2009, and according to our analysis it may continue for quite a while.

In light of this, a growing number of economists have warned of an inflating Chinese real estate bubble and have speculated about the potential consequences of a crash for Chinese and global growth. However, this market has cooled down a bit during the past couple of years. New home prices have trended downward so far in 2014, and property developers in some places across China have been forced to cut prices, delay new projects and offer potential buyers various kinds of incentives.

Another potential real estate bubble may exist in Sweden. A low level of new construction and cheap mortgages have caused Swedish home prices to more than double since 2000, and foreign experts such as Nouriel Roubini and Robert Shiller have warned about bubble tendencies in the Swedish real estate market. Yet the housing market in Sweden is unique in some respects. The absence of rental options in cities such as Stockholm, Gothenburg and Malmö – combined with substantial migration into these urban areas and a low level of new construction – has led other analysts to believe that Swedish homes are not overvalued.

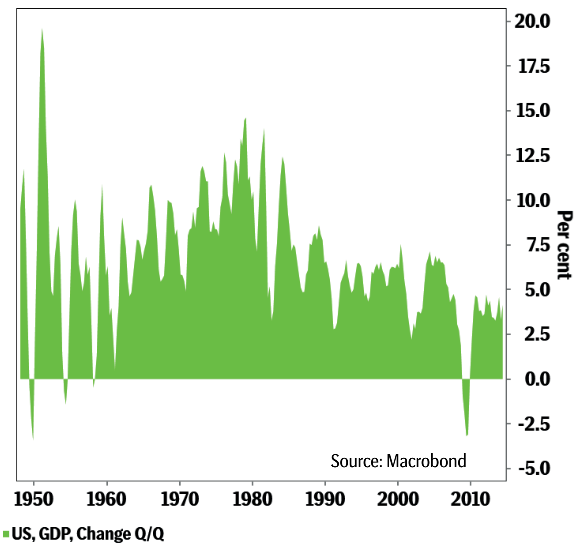
Whether equities are overvalued or not depends, of course, on what stock market and sectors are analysed. After sharp price upturns for more than five years in many stock markets, some analysts believe overvaluations are now a general problem. However, our view is that stock market valuations can be regarded as roughly in line with historical averages but that there are bubble tendencies in small caps, companies that work with social media and biotechnology. Meanwhile, the existence of bubble tendencies in some sectors of the stock market could provide good opportunities to buy in other sectors, whose relatively low valuations make them attractive.

To summarise, the factors that have usually interrupted economic upturns and equity bull markets as well as other risk assets are: 1) Rapid growth and high capacity utilisation, which make costs and prices rise faster. Central banks then hike their key interest rates and bond yields rise, leading companies to lower their inventories and capital spending, and households to reduce consumption. 2) Dramatic commodity price hikes, especially for oil, eroding purchasing power in oil-importing countries leading to higher inflation and current account deficits, causing key interest rates to be hiked and bond yields to rise. 3) Burst speculative bubbles resulting in dramatic price declines for financial assets and real estate, with a consequent risk of general price declines in the real economy (deflation) as well. Governments, households and companies are then forced to increase their saving and reduce debt, and a deep recession follows.

SEB's current analyses in this issue of *Investment Outlook* and in *Nordic Outlook* sketch a main scenario that reflects a rather low risk that the stock market and cyclical upturn that began in the spring and summer of 2009 will be interrupted. Instead SEB's basic assumption is that this upturn can continue for quite a while.

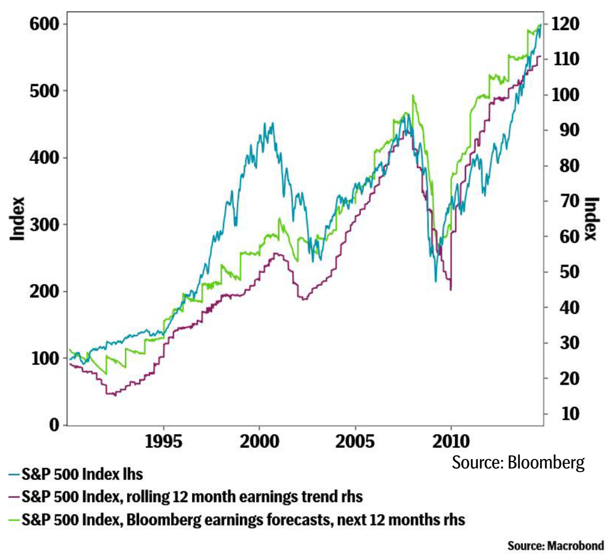
In this theme article, much of the analysis has centred on the US economy and stock market, with US macroeconomic data being used to illustrate the movements of the economic cycle for much of the post-war period. At present, there is reason to believe the US economy has the potential to continue expanding for at least another few years. The same is true of the economies in Britain and Asia including Japan. In the euro zone, by all indications it will take even longer before there is a risk that shortages of spare capacity will bring an economic upturn to a halt.

LONGER AND SLOWER UPTURNS



The latest US economic upturns have been longer and slower as well as somewhat more volatile than the first few post-war upturns (with the 1960s as a partial exception). The main reason for this is the type of recession preceding the upturn. The most recent recessions were triggered by burst speculative bubbles.

EARNINGS GROWTH BOLSTERS STOCK MARKET RALLIES



Stock market rallies, illustrated in the chart by the S&P 500 in the US, are bolstered by a good earnings trend and expectations of continued earnings growth. The stock market can cope with higher valuations as long as the underlying economy is strong and earnings are rising.

Energetic Asian tigers

Many of Asia's economies and stock markets are interesting, but some are especially attractive. According to our combined macroeconomic and equity-related ratios, the most energetic Asian stock market tigers are Taiwan and Singapore.

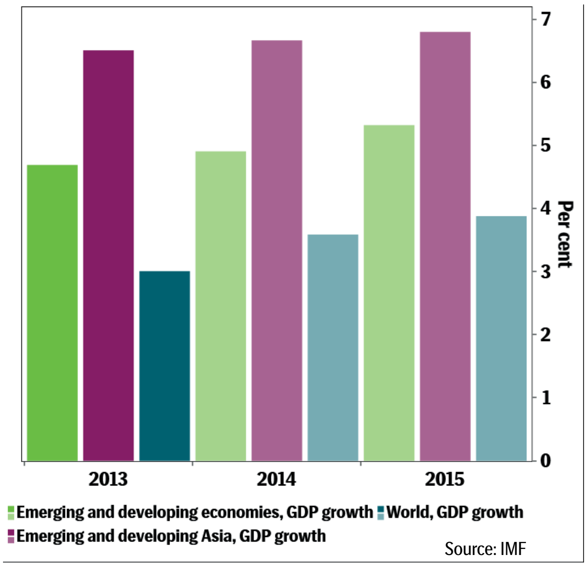
In many ways, Asia's emerging market (EM) economies have made impressive, exciting and dramatic progress over the past 20 years or so. Last year's EM financial market drama, culminating only in January 2014, helped cool off economic growth in the entire EM sphere. The triggering factor was a speech on May 22, 2013 by then-Federal Reserve Chairman Ben Bernanke announcing that the Fed would probably soon begin to phase out its large stimulative bond purchases. The resulting upturn in US Treasury yields caused similar government bond yields in the EM sphere to surge, EM stock markets to plunge and credit default swap (CDS) premiums – a form of insurance against sovereign defaults – to climb. Offsetting this financial tightening to some extent was a decline in the value of EM currencies, benefiting exports.

Early in 2014 the financial market situation stabilised. Global investors were again persuaded to buy EM equities and bonds, including those in emerging Asia. This demand also strengthened EM currencies, especially in Asia. In addition, weaker economic conditions during the first half of the year have now been followed by signs of somewhat faster growth, thanks to better international demand and more favourable domestic market trends in many countries.

Emerging Asia: 30 per cent of the world economy

Our definition of emerging Asia includes 33 economies – the 29 regarded as part of Emerging and Developing Asia plus four that the International Monetary Fund (IMF) classifies as advanced economies: South Korea, Taiwan, Hong Kong and Singapore. By our definition, emerging Asian GDP in current prices and purchasing power parities (PPP) totals USD 25.881 trillion, equivalent to nearly 30 per cent of the world economy and almost 55 per cent of the whole EM sphere (source: IMF).

According to SEB's assessment, economic conditions in emerging Asia will improve during the next few quarters. Exports to the developed markets of the 34-nation Organisation for



EMERGING ASIA WILL CONTINUE TO LEAD THE ECONOMIC GROWTH RACE

While GDP in the emerging market sphere will grow substantially faster than world GDP in 2013-2015, growth in "emerging and developing Asia" will be well above the EM sphere average. In other words, emerging Asia will remain the fastest-growing part of the global economy.

Economic Cooperation and Development (OECD) will increase faster, while still-expansionary monetary policies and strong labour markets will benefit domestic demand. Inflation will remain low for another while in most countries, with India and Indonesia as exceptions.

Credit tightening likely in 2015

This expansion will nevertheless slow in 2015 as growth decelerates in the region's largest economy, China. Many Asian countries will begin to tighten their monetary policies, mainly due to undesirably rapid credit growth. The economic impact of credit tightening may be substantial in some countries, but the probability of a decline in activity similar to what happened in the 1997 Asian financial crisis is small, since today the region is characterised by floating exchange rates and stronger current account balances. One uncertainty factor, of course, is the Fed's upcoming monetary policy tightening (see the "Fixed income" section), but we believe that the 2013 EM financial market drama will not be repeated.

From a macroeconomic standpoint, Asia as a whole is interesting. But for equity investors, seven stock markets in the region – aside from those of China, India and Japan – are of greater interest than others. These are in South Korea, Indonesia, Taiwan, Thailand, Malaysia, the Philippines and Singapore. We focus on these markets below. To obtain key ratios that are as reliable as possible and get a picture of each stock market based on their largest, most liquid shares, we have also limited our key ratio analysis to indices consisting of the largest shares in each market.

Domestically or globally exposed?

As an international equity investor, it is very important to know what exposure an investment provides. Asian stock markets offer a wide range of exposures. Those in South Korea and Taiwan are dominated by electronics companies with global sales, providing only limited exposure to their national economies. In the Philippines and Indonesia, however, the stock markets are instead dominated by domestically oriented companies.

Temporary slowdown in South Korea

By an ample margin, South Korea has the largest economy of our seven markets. Last year, GDP adjusted for purchasing power (PPP) totalled USD 1.667 trillion, while nominal GDP per capita was USD 26,100.

The country's overall 2014-2015 macroeconomic outlook seems promising, with good growth, low inflation and both public sector and current account surpluses. So far this year, however, the economy has been somewhat hesitant because the domestic market has been weighed down by high private debt (about 70 per cent of GDP). Exports to other Asian countries have been weak. In August, exports were also curtailed by an automotive industry strike. Higher global growth ahead would be very helpful to export-dependent South Korea.

By all indications, inflation will fall in the short term. Along with relatively weak demand for capital spending, this will lead to a growing surplus of savings and accompanying downward pressure on market interest rates. SEB predicts that the key interest rate, which was lowered in mid-August, will remain at 2.25 per cent until summer 2015 and then gradually be raised. Despite the slightly hesitant economy, the Korean won (KRW) has gained strength so far in 2014. We believe it will continue to appreciate against the US dollar during the coming year.

Large exporters dominate the stock market

The Stock Market Division of the Korea Exchange is the largest stock exchange we are looking at closely in this issue. Only one fifth of market capitalisation is in sectors with large exposure to the domestic economy, such as construction, retailing and banking.

Samsung Electronics, a conglomerate with operations ranging from mobile phones to home electronics, semiconductors and monitors, by itself has as large a market cap as all domestically oriented sectors combined. The five largest listed companies also include carmaker Hyundai Motor, semiconductor giant SK Hynix, steelmaker POSCO and automotive component manufacturer Hyundai Mobis. There are many other sizeable companies in electronics, chemicals, vehicles and heavy industry. In fact, the South Korean stock market is so heavily exposed to the global industrial economy that its KOSPI index is used in some contexts as an international economic indicator.

Hardly surprisingly, this is also reflected in the declining trend of earnings for South Korean listed companies in the past three years. Analysts are hopeful of a rebound this year, despite the worsening profitability of Samsung Electronics' flagship mobile phone division. Consensus expectations are for full-year earnings growth of 6 per cent. Of the Asian stock markets examined in this article, South Korea's is also one of two that are valued today at a significant discount, 29 per cent, compared to its average for the past 10 years. Dividend yield is traditionally low in South Korea, and today's 1.4 per cent is not internationally competitive. The consensus forecast of a price/earnings ratio of 11 for this year is by far the cheapest in the region, yet 5 per cent above the average for the past 10 years.

Macro key ratios not favourable for Indonesia

Indonesia's GDP totalled USD 1.293 trillion in PPP terms during 2013, while nominal GDP per capita was USD 3,470. Key financial ratios for the Indonesian economy this year and in 2015 are not as good as those in South Korea, for example. Despite a slowdown since last year, among other things due to reduced demand from China, growth remains high. But inflation and unemployment are also high, and public finances as well as the current account are in deficit.

The country's rapid credit growth has been curtailed with the help of key interest rate hikes to 7.50 per cent, and both household debt (about 15 per cent of GDP) and public sector debt (less than 30 per cent of GDP) are low in an Asian comparison.

We expect the Indonesian rupiah (IDR) – which has performed well this year thanks to a better trade balance, reform hopes following the election of populist Joko Widodo as president and lower inflation – to continue climbing in value against the USD until autumn 2015. However, Indonesia's role as a commodities exporter is a risk factor in itself; another is the impact on inflation from a phase-out of the country's large petrol price subsidies.

Stable industries but high stock market valuations

Like Malaysia and Thailand, Indonesia offers a relatively large proportion of defensive shares in such industries as tobacco, gas distribution and telecom operations. Sectors with this kind of limited cyclical exposure make up nearly 40 per cent of the LQ-45 index on the Indonesia Stock Exchange. Meanwhile Indonesia is second only to the Philippines as the Asian stock exchange with the biggest exposure to the domestic economy. As in the Philippines, this has helped generate strong earnings growth and good stock market performance for a long time, but also high valuations. Weighing together key ratios, the Indonesian exchange is the most expensive in the region after the Philippines.

Taiwan's economy internationally dependent

In 2013, Taiwan's GDP in purchasing power parities totalled USD 929 billion. Nominal GDP per capita was USD 21,100.

Unlike Indonesia, but like Singapore, Taiwan shows very good macroeconomic key ratios, but with one exception: public finances are in deficit. Exports are equivalent to more than 70 per cent of GDP, which means that the Taiwanese economy is largely dependent on international events. The stronger global economic situation, led by the US, thus bodes well for Taiwan's growth in 2014-2015.

SEB believes that the central bank will begin hiking the key interest rate, now just below 1.9 per cent, during the summer of 2015. Meanwhile the Taiwan dollar (TWD) is expected to level out against the USD during the coming year.

Taiwan – the electronic stock market

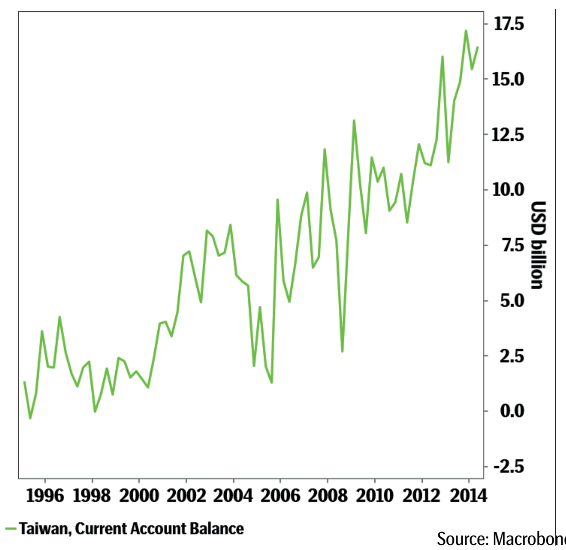
Like South Korea, Taiwan has an exchange with high international exposure, but more intensively focused on information technology (IT) and electronics, which together account for nearly half the index. The largest companies are TSMC, an internationally leading contract manufacturer of semiconductors, and electronics contract manufacturer Hon Hai Precision (best known under its Foxconn trademark and for its enormous workforce of 1.3 million). Less than 30 per cent of the exchange consists of industries that are more dependent on the domestic economy, for example banking, real estate, construction, construction materials and retailing.

Taiwanese listed companies have shown a strong earnings trend so far this year. Analysts expect 28 per cent earnings growth for 2014 as a whole, which is among the best levels in the world and gives Taiwan a clear first place in Asia. Earnings forecasts have also been revised upward in the past month. This distinguishes Taiwan from other markets in the region. While Samsung Electronics in South Korea suffers heavy competition from successful American IT companies like Apple, Taiwanese companies are instead benefiting in their capacity as sub-contractors. The stock exchange is not strikingly cheap; shareholders' equity is valued 17 per cent above the average for the past 10 years, but a combination of strong earnings growth, a positive macro situation and acceptable valuations makes Taiwan one of the two most attractive stock markets in the region, in our judgement.

Outlook in Thailand highly dependent on politics

Last year Thailand's GDP in PPP terms was USD 674 billion. Nominal GDP per capital was USD 5,700.

Except for public sector deficits, forecasts for Thailand show favourable macroeconomic key ratios this year and next, but this presupposes a lack of disruptive political events. During the first quarter of 2014, political turbulence led to a decline in GDP.



Source: Macrobond

TAIWAN'S ECONOMY HAS MANY STRENGTHS

With exports equivalent to more than 70 per cent of its economy, Taiwan is closely interwoven with international events. Its external balance of payments is improving, as evidenced by a growing current account surplus (chart). Other strengths are good growth, low inflation and a small public sector debt.

Since then, the military takeover of power has reduced the level of politically related protests. Infrastructure investments are now being planned and exports may regain better momentum, but a sustained economic upturn will require a successful return of power to a popularly elected government.

Credit growth and public sector debt in Thailand are not high compared to other Asian countries, but the level of household debt is high. We expect the key interest rate to remain at 2 per cent for another year or so and then be raised step by step. Meanwhile we forecast that the Thai baht will fall in value against the USD until autumn 2015.

No political discount on the Bangkok stock exchange

Its structure gives the Stock Exchange of Thailand a middling position in the region on nearly all dimensions. Exposure to the domestic economy is less than in the other Southeast Asian countries but larger than in South Korea and Taiwan. However, the export sector is mainly represented by commodities, especially the state-controlled oil company PTT including its two separately listed subsidiaries PTT Exploration & Production och PTT Global Chemical (petrochemicals). Meanwhile there is a large element of cyclically insensitive companies, but less than in Indonesia and Malaysia. Such industries as telecom operations, convenience goods, health care and electric power represent one third of total market capitalisation. In terms of valuations, Thailand is also in the middle according to most variables. Despite unusually great political turmoil, P/E ratios and shareholder equity valuations are well above historic averages, but dividend yield – at a bit less than 3.2 per cent – is next highest in the region after Singapore.

Malaysia needs a touch of the brakes

Malaysia's GDP was USD 526 billion in PPP terms last year. Nominal GDP per capita was USD 10,400.

Malaysia is one of many Asian countries with a public budget deficit, but is otherwise similar to Indonesia in terms of growth prospects and has a strong current account and lower inflation than most of its neighbours. GDP rose surprisingly fast during the second quarter, but economic policy tightening is now holding back further acceleration. This year petrol prices have been raised sharply, and a new goods and services tax (GST) will be introduced in 2015. But since Malaysia is one of Asia's most open economies, stronger international demand will provide a helping hand. In light of this, it will be reasonable to gradually raise the key interest rate from today's 3.25 per cent. SEB believes that the Malaysian ringgit (MYR) will fall somewhat in value against the USD during the coming year. Public sector debt (70 per cent of GDP) is the second highest among our seven nations, and household debt tops the list. On the other hand, credit growth is moderate.

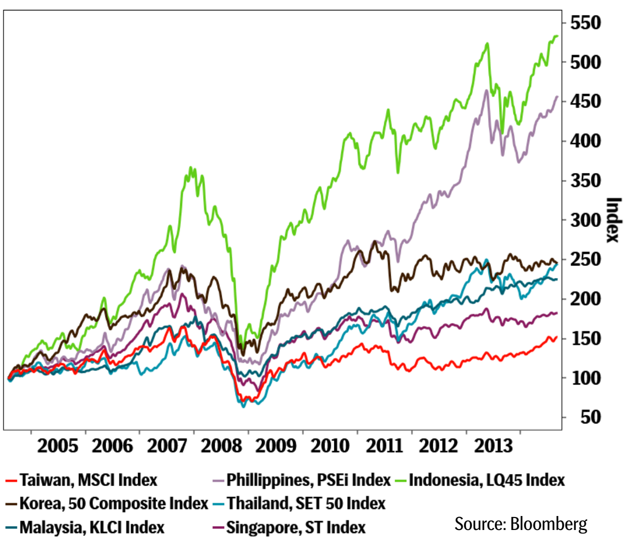
Stable industries but high valuations in Malaysia too

Bursa Malaysia, the stock exchange in Kuala Lumpur, is very similar to the Indonesia Stock Exchange in having a large element of defensive sectors such as tobacco, telecom operations, food, electrical power and gas distribution. Almost 40 per cent of market cap is found in such relatively non-cyclical industries and one fourth in banking. With a P/E ratio of 16.9 and a premium of nearly 20 per cent compared to historically average shareholders' equity valuations, as well as the second-lowest expected earnings growth in the region during the next two years, the Bursa Malaysia does not seem especially attractive.

Philippines showing good macroeconomic strength

During 2013, Philippine GDP was USD 456 billion in PPP terms. Nominal per capita income was USD 2,700.

The Philippines also noted a public sector budget deficit, while other key ratios reflect high growth and a good macroeconomic balance; the rating agencies S&P and Fitch recently raised the country's sovereign credit rating to investment grade. Inflation looks set to be moderate in 2014-2015, but is currently higher than the key interest rate (3.75 per cent). It is thus likely that the key rate will be raised again during the coming months. As for the Philippine peso (PHP), SEB does not expect any large exchange rate movements against the USD between now and autumn 2015. Another reason to tighten monetary policy is high credit growth. Here the Philippines is on top ahead of Singapore. Meanwhile public sector debt is moderate (about 50 per cent of GDP) and household debt is nearly negligible, according to official statistics.



Source: Bloomberg

ROLE REVERSAL AFTER 10 YEARS?

The chart shows the performance of stock market indices in the Philippines, Malaysia, Indonesia, Singapore, South Korea, Taiwan and Thailand, calculated in Swedish kronor over the past 10 years. Stock markets with large exposure to the domestic economy combined with relatively high economic growth, like the Philippines and Indonesia, have performed by far the best. Yet the upturn in the winning countries has not only been a function of strong earnings growth, but also of sharp expansion of multiples. There is a clear risk that the big winners of the past decade may need a period of consolidation. Meanwhile valuations look more attractive in two lagging stock markets, Taiwan and Singapore.

Attractive profile means expensive shares

The Philippine Stock Exchange stands out by offering unusually high exposure to the domestic economy. Nearly 60 per cent of the index consists of sectors with a clear connection to the domestic economy, such as retailing, real estate and banking. Another 30 per cent consists of relatively non-cyclical industries such as telecom operations and power companies, and less than 10 per cent consists of exporters and commodity producers. It is the smallest of the seven Asian stock exchanges examined in this article, but it is still an important stock market.

Favourable economic and political developments under President Benigno Aquino III have turned listed companies in the Philippines into winners, with earnings growth of more than 12 per cent annually over the past 10 years. The Philippine Stock Exchange has turned in an incredible performance: a 627 per cent return in Swedish kronor in the past 10 years and 211 per cent in the past five years, which is more than three times better than the MSCI All Country Asia ex Japan. Unfortunately, historical returns do not guarantee future returns and the Exchange is now expensive, with a P/E ratio of 20. This is 48 per cent above its average for the past 10 years and well above the rest of the region. Shareholders' equity is valued 65 per cent higher than the average for the past 10 years, which stands out as expensive in an international perspective.

Singapore easily meeting "textbook targets"

Last year's Singapore GDP in PPP terms was USD 325 billion. Nominal GDP per capita was USD 54,600.

During 2014-2015, Singapore will easily achieve "textbook targets" for an economy: good growth, low inflation, low unemployment plus public sector and current account balances or surpluses. The Singapore economy has recently gained strength, among other things due to exports. But growth will probably not accelerate much more because Singapore, like China, is now prioritising balance and quality rather than rapid expansion. Looking ahead, however, household consumption may grow faster as immigration is curtailed, contributing to more jobs and higher pay for the country's low income earners. As a result, inflation may also climb a little, but the prospects of Singapore dollar (SGD) appreciation against the USD will limit the price upturn.

Although most macro conditions in Singapore seem outstanding, there are a few risks. One is rapid credit growth – second fastest after the Philippines. In relation to GDP growth, this puts Singapore at the top among our seven markets. Another risk is high debt among households. Among heavily indebted companies, real estate enterprises and automotive manufacturers are in the worst situation if interest rates should rise rapidly.

Financial sector dominates equities

Singapore has a sizeable financial sector and banks are by far the biggest sector on the stock exchange, about 30 per cent. Real estate is also important at 15 per cent, but the two largest real estate companies focus on Hong Kong and China, not Singapore. There are also some major industrial companies with a maritime focus, but on the whole the Singapore Exchange still provides substantial exposure to the city state's domestic economy. After a couple of years of a weak earnings trend, 2014 began with signs of hope, but analysts still fear that the year will end up with 5 per cent negative company earnings growth. Valuations of shareholders' equity on the Singapore Exchange are lower than normal, offering a 27 per cent discount on the average for the past nine years, while most stock exchanges in the region are valued higher than their 10-year averages. At 3.2 per cent, dividend yield is the best in the region and only marginally below the average for European equities. The combination of relatively attractive valuations and a positive macro situation, as well as a stock market structure that gives investors exposure to this good macro environment, is attractive.

Conclusion

To summarise, equities in the region are not especially cheap but there are good reasons for this. Weighing together the macro situation and key ratios for listed companies, Singapore and Taiwan appear to be the two most attractive markets, while the Philippines looks expensive despite fine economic performance.

Market	Capitalisation, SEK M	P/E ratio, 2014	P/E premium/ discount on 10-year average	Dividend yield	Price/book value ratio	Historical P/ BV premium/ discount	Earnings growth, 2014	Earnings growth, 2015
South Korea	8,159,185	10.9	5%	1.4%	1.0	-29%	5%	15%
Taiwan	6,245,641	15.1	10%	3.0%	2.2	17%	28%	6%
Singapore*	3,946,929	14.8	4%	3.2%	1.4	-27%	-5%	9%
Malaysia	3,308,792	16.9	19%	3.1%	2.3	19%	-1%	9%
Thailand	3,069,245	15.3	59%	3.2%	2.4	17%	1%	14%
Indonesia	2,852,351	16.5	49%	2.4%	3.6	47%	6%	14%
The Philippines	2,148,029	20.2	48%	2.0%	2.9	65%	4%	16%

** Historical figures based on 9-year averages*

Source: Bloomberg

Strong growth for emerging market bonds

Over the past 10 years, bonds issued by emerging market (EM) players have attracted more and more capital. The volume of both corporate and government bonds issued has increased sharply, while investors have earned good returns on them.

When the US Federal Reserve announced in May 2013 that it planned to phase out its monetary stimulus programmes and raise key interest rates, this had a relatively strong negative impact during the second half of the year. In a long-term perspective, however, this period does not seem so dramatic. The current environment of ultra-loose monetary policies and interest rates near zero in much of the developed world will generate continued interest in emerging market bonds.

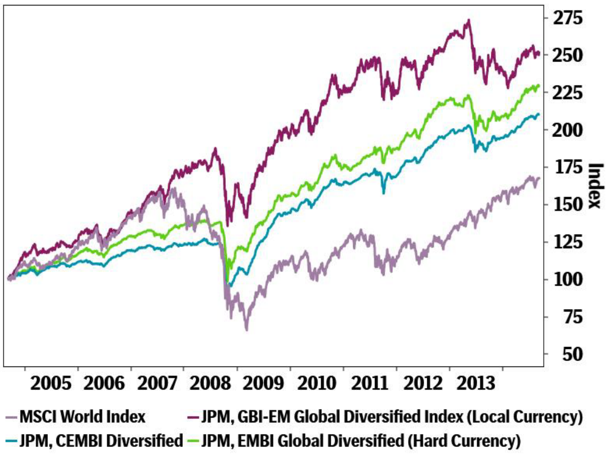
In recent years, the challenge of generating returns on investments in the fixed income asset class has become greater, unless investors have been willing to increase their risk-taking. Corporate bonds issued by companies with high credit ratings (investment grade, IG) in developed market (DM) countries have not offered returns of much more than one per cent or so. Because of the search for returns, a lot of capital has flowed into DM corporate bonds with lower credit ratings, so-called high yield (HY) bonds, a type of asset that performed very strongly over many years. But bonds issued in emerging markets (EM) countries have also attracted increasing interest among investors, since in many cases their yields have been significantly higher than in the DM sphere.

Interest in EM bonds is not a new phenomenon, although it has increased in recent years. For a long time, this market has shown strong growth in terms of outstanding volume, number of issuers and categories of buyers.

The market consists mainly of government bonds issued by emerging countries and bonds issued by companies domiciled in these countries. Both categories are issued either in local currencies or in hard currencies (mainly USD), although the majority of corporate bond issues still occur using hard currencies.

One illustration of the rapid growth this type of asset has shown is that total outstanding volume of EM bonds issued in hard currencies (USD and EUR) has grown by an average of 12.5 percent annually over the past 15 years. Having been a relatively small market, totalling about USD 285 billion at the end of 1988, EM bonds grew to a total of about USD 1,697 billion by January 2014, thus growing six-fold. The EM corporate bond market has shown even faster volume growth. In 1988, total outstanding volume was equivalent to about 3.5 per cent of bonds issued by companies in the EU and the US. Today's figure is 17 per cent. Since the turn of the millennium, volume has increased from USD 144 billion to USD 1,513 billion. Of this volume, investment grade loans account for more than 70 per cent. After this eight-fold increase, outstanding volume is now on a par with that of American HY bonds and is thus an important investor segment.

EM BONDS HAVE PERFORMED WELL



Source: JPMorgan/Bloomberg

As the chart indicates, the performance of bonds issued in emerging markets has been very strong. Both EM government and corporate bonds have surpassed the performance of world equities during the past 10 years. It is also clear that volatility has been substantially higher for bonds issued in local currencies compared to hard currency bonds.

Several reasons behind market growth

One important reason why the EM bond market has grown so dramatically is that both emerging market countries and companies have shown increasingly good health. EM public sector debt has decreased as a percentage of GDP, and in many cases public finances are stronger in these countries than in the developed world. As a consequence, the average credit rating for both governments and companies in emerging markets has greatly improved in the past 15 years. However, it is worth noting that on average, companies in the EM sphere have a better credit rating than governments. During the same period, the credit-worthiness of US companies has deteriorated somewhat and is now essentially on a par with the EM level. At present, average leveraging by companies with lower credit ratings (HY) in the EM countries is also lower than the equivalent in the DM sphere. Our conclusion is that in terms of credit risk, the EM bond market is no more risky than US corporate bonds and that more and more investors are seeing this type of asset as an important part of a diversified portfolio.

The current financial environment, with ultra-loose monetary policies in much of the DM sphere and ever-increasing challenges for investors to find returns – combined with expectations of rising interest rates and yields as well as historically attractive total returns on EM bonds – has also contributed to increased investor interest.

As the market has grown and more and more categories of investors have moved into this type of asset, liquidity has also improved and markets have functioned better. Historically, a majority of all EM bonds have been owned by investors from the developed world, but this pattern has gradually changed.

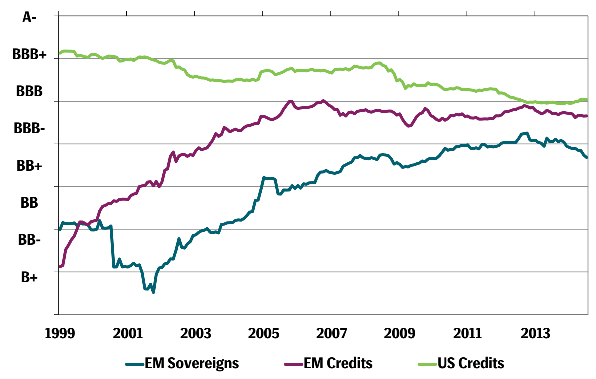
EM bonds also provide portfolio diversification. Although their correlation with both equities and HY bonds issued in the DM sphere is relatively high, their correlation with such assets as US government securities is very low. Over the past seven years, the correlation between hard currency EM corporate bonds (according to the JPM CEMBI Diversified TR USD Index) and global equities (according to the MSCI AC World Index) was 0.71, and the correlation with an HY index (BoAML Global High Yield TR) was 0.79. For EM government bonds issued in local currencies (as measured by the JPM GBI EM Global Diversified TR), the corresponding figures were 0.81 and 0.69. It is worth noting that EM government bonds issued in local currencies thus have a higher correlation with the stock market, but lower correlation with the HY market in the DM countries.

Sources of risks and returns

Since the EM bond universe consists of bonds issued by both companies and governments, denominated in both local currencies and hard currencies, it is important for investors to be aware of how this may affect their holdings in terms of expected risks and returns.

If we look back 10 years and compare returns on EM bonds in local and hard currencies to those of other types of assets

BETTER EM CREDIT RATINGS NARROW GAP TO US BONDS



Source: JPMorgan

The chart shows the changes in the average credit rating for US companies as well as emerging market governments and companies over the past 15 years. A- is the highest rating and B+ is the lowest on the y axis. As indicated, the gap in credit ratings was sizeable in 1999 but these ratings are now essentially on a par.

like equities and HY bonds issued in DM countries, we can conclude that EM bonds stand up very well in this comparison. If we study the performance of local currency EM bonds during the period January 2003 – March 2013, we note that a USD-based investor received an average return of 12.3 per cent per year. This return was driven by three relatively uncorrelated sources: interest rates, currency exchange rates and changes in the value of the bond. It turns out that a full 40 per cent of the return was generated from currency appreciation, 44 per cent from interest rates and 16 per cent from higher bond price, in other words, lower yield. The contribution of currency rates to the volatility of returns was also significant. In the past two years, volatility has been about 10 percent, with currency rates accounting for more than half.

Obviously it is especially important to have some idea of how currencies will perform when investing in emerging market bonds denominated in local currencies, or at least be aware of the potential impact of currency rate movements. During two years, 2008 and 2009, there were negative returns, in both years entirely due to exchange rate shifts.

If we instead choose to invest in bonds issued in hard currencies, currency rates will not be an equally crucial factor. With corporate bonds, on the other hand, we should keep in mind that the company that issued the bond may risk both higher borrowing costs and higher debt if the hard currency appreciates. If they have export revenues in the same hard currency, of course, this will be partly offset.

Most observers agree that investor interest in EM bonds will continue to grow for many more years to come. We believe that they are an attractive investment and fulfil their function in a diversified portfolio.

Follow-up – Eastern Europe squeezed between geopolitical risk and less outside stimulus

In recent months, the Ukraine crisis has escalated and the economic situation in the euro zone has weakened – a combination that has had a negative impact on the economy in Eastern (including Central) Europe. The region's stock markets have reacted calmly, however. We continue to prefer stock exchanges in the western part of Eastern Europe to those in the eastern part.

Since we published the Eastern Europe theme article in the May issue of *Investment Outlook*, most geopolitical and macroeconomic developments in the region have been in the wrong direction.

In particular, the conflict between Ukraine and Russia has escalated in several stages. Geopolitical trouble spots such as this one, Gaza and Iraq/Islamic State are creating greater uncertainty among investors, who thus demand a higher risk premium. As for the Ukraine crisis, it risks both short- and long-term negative consequences for economic growth in large parts of Eastern Europe (especially in the former Soviet republics) and also in those Western countries that have strong economic ties with Eastern Europe. The overall global geopolitical risk level has risen sharply in recent months and by all indications this serious risk situation will persist during the foreseeable future.

To make matters worse, economic conditions in the euro zone including Germany have weakened significantly, as illustrated by stagnant second quarter GDP in the currency union as a whole and falling German GDP. Such a turn of events in continental Western Europe is detrimental to its nearest eastern neighbours. One reason is their large trade with Western Europe. For example, 25-30 per cent of Polish and Czech exports are destined for Germany. Another reason is mutual ties in the banking sector and stock markets.

Lower euro zone economic growth thus means less macroeconomic stimulus from the outside for countries like Poland, the Czech Republic and Romania. Meanwhile, weaker stock market performance in Western Europe may have an adverse impact on stock markets in neighbouring countries to the east. In spite of this, indices on major Eastern European stock exchanges have been basically unchanged since late May in terms of Swedish kronor. The exception is Austria, whose stock market has dropped by about 5 per cent.

In our May theme article, we chose to include Austria because the Vienna Stock Exchange is dominated by companies with major operations in Eastern Europe. Aside from the headwinds these companies have recently faced, Austrian banks focusing on Eastern Europe have been affected by political decisions in Hungary. These decisions are forcing banks to compensate customers for their losses on foreign currency-denominated loans due to the depreciation of the Hungarian forint. Austrian banks also remain squeezed by credit losses in the region and have been hurt by EU sanctions against Russia.

Stock markets in Eastern Europe are still undervalued, both compared to other countries and historically. Russian shares are valued at a price/earnings ratio of 5, which is unusually low even for Russia. Seven years ago, the average was 8. Meanwhile the shareholders' equity of companies is being valued at 45 per cent less than normal, and dividend yield is 4.7 percent.

Polish shares are valued at a P/E ratio of 15, which is higher than normal and is due to depressed earnings. Shareholders' equity is valued at a discount of 25 per cent compared to the average over the past seven years, and dividend yield is 4.2 percent. In our opinion, political risk in Russia is significantly higher than in Poland and Austria, so a bigger discount on these exchanges may be justified.

Analysts are predicting a surge in earnings for listed companies in Poland (13 per cent) and Austria (80 per cent) as well as the Czech Republic (60 per cent). Our crystal ball also shows slightly better economic conditions in the euro zone over the next two years, which would provide outside stimulus to their eastern neighbouring countries.

We are sticking to our assessment that the ratio between potential and risk is more attractive in the western parts of Eastern Europe, especially Poland, than further east, where the only relevant stock market is the one in Russia.

World economy continues upward

- *The global economy keeps climbing, but its progress is shaky and its strength varies*
- *Continued large-scale monetary policy stimulus and fading fiscal austerity will help*
- *Geopolitical risks and a wobbly euro zone economy may pose obstacles; unexpectedly strong US growth may provide more fuel*

The world economy continues its upturn, which is both fragile and shows geographically different rates. Geopolitical trouble spots and the trade conflict between Russia and the United States/European Union have not yet had any deeply negative impact on global economic conditions. Developed market (DM) monetary policies remain stimulative and fiscal policies are shifting towards a neutral stance after earlier austerity. Low inflation persists, but the pattern is divergent, with deflation risks in various European countries and gradually accelerating US price increases. Looking ahead a couple of years, growth in the overall emerging market (EM) sphere may speed up, with emerging Asia clearly leading the way. The danger of escalating geopolitical risks and worse-than-expected economic conditions in the euro zone are the biggest downside risks, while the main upside chance is whether the US may provide unexpectedly powerful help to the global economy.

US economy heats up after frosty start to 2014

The US economic slump in the first quarter was due to temporary factors, mainly unfavourable winter weather but also destocking in the automotive industry. Second quarter growth rebounded to an annualised 4.2 per cent and early indicators suggest a continued good economic pace during the rest of 2014. We expect gross domestic product (GDP) to grow by more than 2 per cent this year, 3.5 per cent in 2015 and over 3 per cent in 2016. Looking ahead, the inflation rate looks set to increase, but the upturn is likely to be rather gentle. Stronger economic conditions will persuade the Federal Reserve (Fed) to phase out stimulative bond purchases this October and begin to hike its key interest rate in April 2015 from the current 0-0.25 per cent.

Euro zone economy treading water

After a decent start to the year, the euro zone has lost momentum. GDP stagnated in the second quarter, when both the Italian and German economies shrank. Disruptions in trade with Russia appear responsible, along with a downward correction after unexpectedly good growth early in 2014. We predict that GDP in the currency union will grow by more than 0.5 per cent this year, above 1 per cent in 2015 and 1.5 per cent in 2016. The chance of gradually higher growth is mainly related to expanded stimulus measures by the European Central Bank (ECB). In addition to the measures it launched in June, we believe the ECB will initiate a large bond-buying programme by spring 2015. Greater help from international expansion is also part of our forecast. Deflation risks persist, but we expect that the euro zone as a whole can avoid this danger.

The British economy shines

The United Kingdom is continuing its broad-based economic expansion. According to our forecast, the UK will achieve the highest GDP growth in 2014 among the G7 major industrial countries: more than 3 per cent. Next year growth will remain at nearly 3 per cent and in 2016 just over 2.5 per cent. Concurrently, we predict inflation will fall below the Bank of England (BoE) target of 2 per cent, but the strong economy will persuade the BoE to start hiking its key interest rate in February from today's 0.50 per cent. The September 18 referendum on Scottish independence is a source of concern, especially because the latest opinion polls indicate an even race.

Nordic economic curves diverging

The Nordic countries are still following slightly different paths. The Swedish economy is showing decent growth due to freely spending households that are enjoying rising real incomes and asset prices. The Norwegian economy is pulling in two directions: a decline in oil and gas industry capital spending as well as weaker residential investments, while a more stable labour market is benefiting private consumption. The Danish economy is gaining strength after several weak years, thanks to more jobs, higher home prices and looser fiscal policy, which will support household spending. The Finnish economy continues to fight an uphill battle; GDP will shrink for the third year in a row. Aside from structural problems in the business sector, Finland is being hurt by Russia's lower growth and import restrictions. In the Nordics as a whole, we predict GDP growth of more than 1.5 per cent this year and above 2 per cent both in 2015 and 2016.

BoJ busy while awaiting impact of the "third arrow"

Japan's GDP surged before April's consumption tax hike, but then fell sharply (an annualised -6.8 per cent) in the second quarter. So far in 2014, manufacturing and exports have been the biggest disappointments. Although the economy is recovering from its spring slump, growth remains slow. We predict that GDP will increase by more than 1 per cent this year and in 2015, and by less than 1 per cent in 2016. Inflation exceeded 3.5 per cent this summer, well above the Bank of Japan (BoJ) target of 2 per cent. But excluding effects of the tax hike, inflation will remain at around 1 per cent, an underlying rate we also foresee in 2015 and 2016. Structural reforms will be the key to higher wage and salary costs and thus Japan's chances of reaching the inflation target. This summer Prime Minister Shinzo Abe launched the "third arrow" (structural reforms) of his Abenomics macroeconomic strategy. But concrete details are missing and it will take time before these reforms affect the economy. The BoJ is thus likely to launch further monetary policy stimulus.

Emerging Asia still in a class of its own

Asia's EM economies are now accelerating because of higher exports to DM countries and stimulative monetary policies. Good job growth is also benefiting domestic markets in many countries. GDP may grow by nearly 7 per cent in 2014-2015 and a bit more slowly in 2016. Inflation pressure remains low in the region, with India and Indonesia as major exceptions. In many countries, there is thus room for continued monetary policy stimulus. Monetary tightening is not expected until next year. Chinese growth was surprisingly high in the first half, with the economy otherwise coping well with the downward spiral in construction, thanks to strong exports and targeted economic policy stimulus. We now foresee a gentle slowdown from this year's rapid pace of 7.5 per cent to about 7 per cent in 2016. In India, there are now high hopes about the economic policy of the new BJP government. Although there is a risk of disappointments related to economic reforms, we still predict that GDP growth can increase from 5 per cent in 2014 to about 6 per cent next year and in 2016.

Latin American economies struggling

Latin America is grappling with macro problems such as lower growth, higher inflation and large current account deficits. After averaging more than 3.5 per cent in the first decade of this century, Brazilian GDP growth has slowed to less than 1 per cent in 2014. The October presidential election has the potential to open the way for necessary structural reforms, but none of the main candidates has shown an impressive reform agenda. Argentina is plagued by high inflation and is technically in default, adding further to its economic woes. Far better macro situations are found in Mexico and Chile. We expect overall GDP in the region to grow by 1.5 per cent this year, about 2 per cent in 2015 and 2.5-3.0 per cent in 2016.

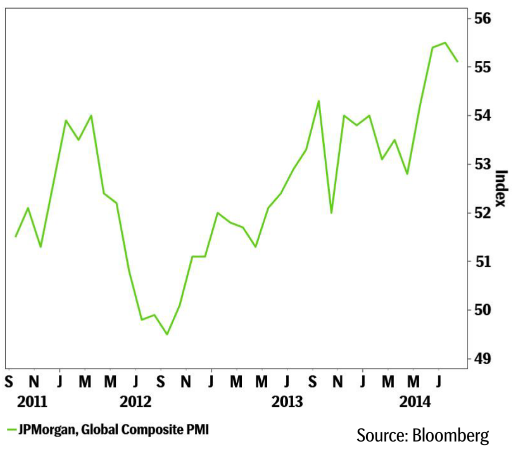
Few bright spots in most of Eastern Europe

The geopolitical conflict in eastern Ukraine is likely to last a long time. To pressure Russia to work towards demilitarising the conflict region, the EU and US have gradually toughened their sanctions. Russia has responded by blocking about 10 per cent of food imports for one year. These measures have a rather low impact, but they increase uncertainty about Russia's already weak economic situation and add to inflation there. Meanwhile Ukraine is deep in recession, with GDP predicted to shrink by 6 per cent this year and then stagnate. The situation and outlook are much brighter in the central as well as southern portions of Eastern Europe. Economies that continue to perform well are Poland, the Czech Republic and Hungary.

The Baltic countries are among those hardest hit by the Russia-Ukraine conflict, since their trade with Russia is extensive. Heightened regional uncertainty is hampering capital spending plans in the Baltics. Russia's food import restrictions will impact Lithuania the most, while Estonia will be hardest hit overall, due to its large exports and its strong ties to recession-plagued Finland. But there are also positive growth forces in the form of private consumption and good momentum in construction, as well as upcoming infrastructure investments.

World growth will gradually accelerate

Global growth will gradually gain momentum. As in 2013, world GDP is expected to increase by nearly 3.5 per cent this year, rising to around 4 per cent both in 2015 and 2016. The EM sphere will continue to grow the fastest, with a pace of 4.5-5.0 per cent in 2014-2016, but the gap between EM and DM countries will shrink in 2014 and 2015, when DM growth will accelerate to 2 and 2.5 per cent, respectively. The gap will again widen somewhat in 2016 as EM growth climbs slightly while DM growth falls marginally.



WORLD ECONOMY MAINTAINING GOOD MOMENTUM

Although the JPM/Markit composite purchasing managers' index fell in August, it remained at a high level that signalled rapid global economic growth. The service sector showed the best momentum, while manufacturing expanded a bit more slowly. Geographically, figures were strongest in the United States and the United Kingdom, while the euro zone economy cooled.

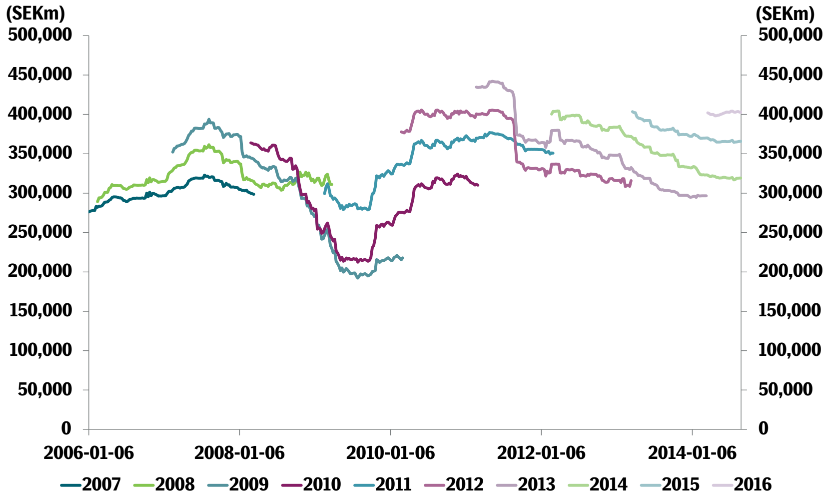
Improved earnings outlook

- **Earnings are now growing**
  After a prolonged period of earnings stagnation, a clear reversal of this trend was discernible in company reports for the second quarter of 2014, although the growth rate is still modest.

- **Stabilisation gives earnings forecasts credibility**
  Not only are reported earnings showing improvement, but the three-year long trend towards continuous downward revisions of forward-looking earnings forecasts now appears to have ended.

- **Strong central bank support**
  The stock market's trump card is still its relative attractiveness. Thanks to exceptionally loose central bank monetary policies, interest rates can be expected to remain historically low for a long time. Compared to the very low return requirements reflected in today's fixed income market, Nordic equities are rather attractively valued.

STABILISED EARNINGS FORECASTS ARE INSPIRING HOPE



Source: SEB

The seagull-wing curves above show aggregated earnings forecasts for Swedish listed companies in SEK million for each year. After three years of steady and sizeable downward revisions, forecasts are now stabilising. This lends credibility to expectations of healthy earnings growth in 2014 and 2015.

OUR OVERALL VIEW OF NORDIC STOCK MARKETS has actually not changed significantly for more than a year. After two years of strong stock market rallies (2012-2013) and shrinking listed company earnings – while analysts' earnings forecasts for the next few years were continuously being revised downward – by the end of 2013 valuations no longer seemed particularly attractive, at least not compared to their own history. When we instead compared equities to other investment alternatives, then as now, a more positive picture emerged. Thanks to exceptionally loose central bank monetary policies, low interest rates and bond yields are expected to continue for a long time. Even without earnings growth in companies and with limited potential for further expansion of multiples, the stock market's 3-4 per cent dividend yields appeared to be a less bad alternative than many others. Overall, the market looked set for consolidation amid a flat trend with a cautiously positive undertone. Although low interest rates are providing support, the lack of earnings growth – combined with fairly high valuations – limits upside potential. This situation now appears likely to persist for some time to come, but the big question is (and was) of course: What happens next?

Consolidation in Sweden, bullish in Denmark

The forecast of flat stock market performance in the Nordic countries came slightly early but has basically proved correct in Sweden and Finland during 2014, at least after the first weeks of January. Although a slightly upward underlying trend can be identified and investors, aside from share price increases, have also received about 3.5 per cent in dividends this year, we see that during August the OMXS30 equity index in Stockholm was at the same level as in January 2014. A flat consolidation is thus an apt description of most of the stock market year so far in Sweden.

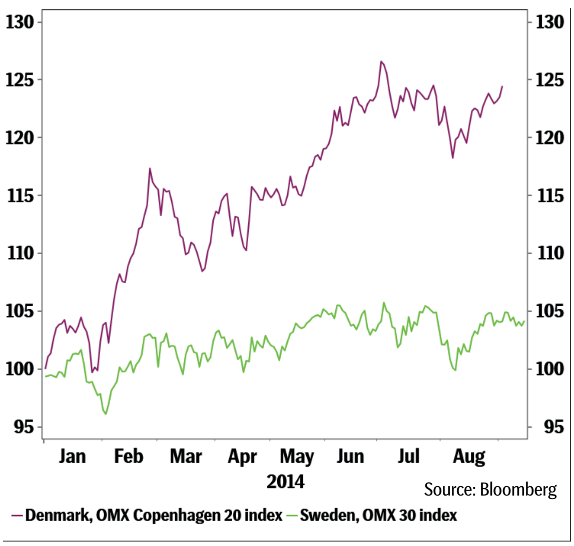
If we look at all four main Nordic countries, however, the 2014 stock market year has been substantially stronger, especially in Denmark, driven by Novo Nordisk. This pharmaceutical company accounts for about 40 percent of the KFX/OMXC20 index and has climbed by 30 per cent this year. The other giant in the index, the AP Møller-Maersk shipping and petroleum group, has also helped. Four other large cap companies noted major share price gains too. It is difficult to identify any common denominator among Copenhagen's stock market stars. Their gains reflect a combination of vigorous cost-cutting, continued good growth and general upward revisions in expectations (often referred to as higher risk appetite or better sentiment). The Nasdaq OMX Copenhagen is somewhat different from the other Nordic stock exchanges in having a large element of growth companies, making it the best Nordic exchange this year, for the past five years and for the past 10 years. Earnings growth will help the exchange in future years as well, but these earnings now carry the highest valuations in the Nordic region, with a P/E ratio of 18.4 for 2014. The potential for further multiple expansion should thus be relatively limited in the near term.

On the Norwegian stock exchange, heavyweight Statoil has contributed to a good market year. In this case, too, the share price increase is primarily due to tighter cost controls, especially with regard to prioritising new projects. Meanwhile oil prices have fallen, despite geopolitical turmoil in the Middle East and Eastern Europe.

What is next for the stock market?

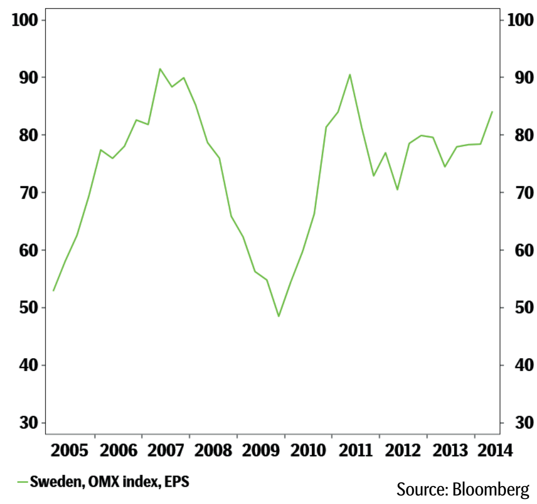
In the near term, we believe that the balance between a nearly fully-valued stock market, modest earnings growth and political unrest on the one hand and low interest rates on the other

CONSOLIDATION IN STOCKHOLM, BULLISH IN COPENHAGEN



The chart shows the performance of the Nasdaq OMX Stockholm (OMXS30) and Copenhagen (OMXC20) in 2014, both expressed in Swedish kronor. A choppy, weakly positive but mainly flat consolidation has characterised the Swedish stock market during most of 2014, while a bull market is evident in Denmark.

EARNINGS ARE GROWING AGAIN



The chart shows the index of reported net earnings during the preceding 12-month period for OMXS30 companies (the 30 biggest stocks on the Nasdaq OMX Stockholm). The improvement in the latest quarter is igniting hopes that the negative earnings trend since 2011 has now reversed.

hand will persist. Looking a bit further ahead, there are reasons to evaluate risks and opportunities in the next phase of development. If central banks are forced to tighten monetary policy before earnings have accelerated significantly, there is potential for a significant stock market decline. Meanwhile, if our earnings forecasts for 2015 and 2016 hold and valuations of earnings remain at current multiples – which is reasonable given the prevailing interest rate outlook – the total return from Nordic stock markets will be very competitive. Today we expect adjusted net earnings growth of 6 per cent this year, 15 per cent in 2015 and 10 per cent in 2016 for Swedish listed companies. The corresponding figures for the entire Nordic region are 15 per cent in 2014, 16 per cent in 2015 and 10 per cent in 2016. Meanwhile dividend yields will be 3.6-4.4 per cent in Sweden and in the Nordic countries overall.

Quarterly reports are encouraging

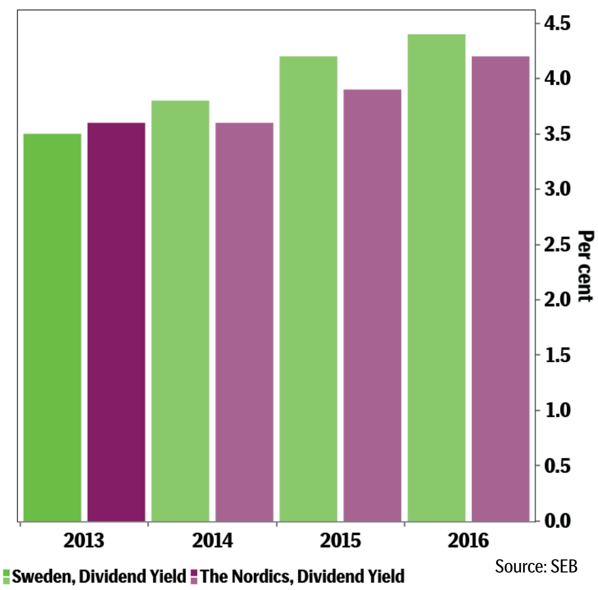
This summer, stock markets have been relatively messy, but the main explanation is increased geopolitical turmoil – especially the conflict in Ukraine. Macro data from the euro zone have also been disappointing, but this is probably also related to the Ukraine crisis. Macro disappointments in the euro zone are also largely offset by expectations of further monetary easing by the European Central Bank (ECB).

If we look at the news flowing from companies themselves, the latest report period was actually the best in a long time and quite encouraging, both in Sweden and other Nordic countries. The aggregate earnings of the OMXS30 companies (the top 30 equities on the Stockholm exchange) reverted to positive growth. Earnings rose to their highest level since 2011 and provide hope that we are seeing a reversal of the multi-year trend of falling or stagnating earnings. In particular, the performance of fashion retailer Hennes & Mauritz and currency-sensitive basic industrial firms (which benefit from krona depreciation) is encouraging, along with trends in the telecom sector.

In addition, earnings forecasts for 2014 and the next couple of years have finally levelled out both in Sweden and in other Nordic countries. Downward revisions during the report period were negligible and a clear stabilisation is apparent in the chart below, which shows earnings forecasts for Swedish listed companies. Stable forecasts are credible forecasts, and a reduced risk of earnings disappointments from companies obviously increases the attractiveness of their shares. Now it is important to ensure that the past quarter was not an exception, but that stability will continue and that the Ukraine crisis will not halt the economic recovery in Europe.

Summary and conclusion

There will be a continued struggle between a hobbled economic recovery, especially in the euro zone, and central banks that are doing everything in their power to accelerate the economy and the inflation rate. The net effect of this should be cautiously positive for the stock market. Compared to the bond market, equities continue to appear attractively valued. After the latest reporting period, there is also nascent hope of improved earnings growth and stabilised forecasts, which may eventually take over as the engine for a further stock market rally when monetary stimulus fades. We expect a continued cautiously positive stock market trend. Together with dividend yield, this will still provide relatively good total returns compared to the alternatives. A troubled world, especially the Ukraine conflict, unfortunately also means that there may be great volatility.



Source: SEB

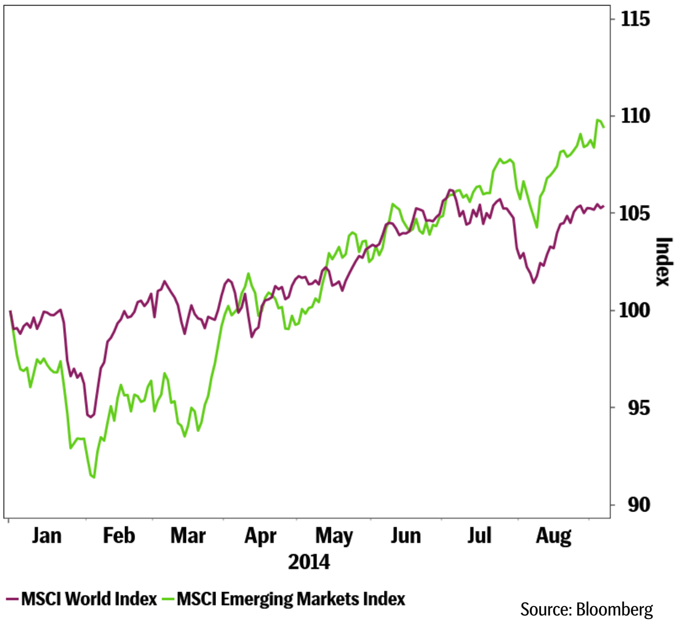
COMPETITIVE DIVIDEND YIELD

The chart shows the dividend yield on the Stockholm exchange and in the Nordic stock market as a whole. In today's interest rate environment, no dramatic share price increase is required to make the total return from equity investments appear competitive.

Green light for equities due to earnings

- **Full speed ahead for global stock markets**
  The benchmark world equities index rose a full 14 per cent in Swedish kronor terms by the end of August this year. The market showed great resilience this summer despite geopolitical tensions in many places around the globe. Emerging market equities are getting revenge, outperforming those in developed markets after having lagged for a long time.
- **Hard to navigate the market**
  After a strong 2013, when active management generated profits for market players, 2014 has been tougher, especially for fund managers in Europe, who have had a hard time outperforming the index. Many funds failed to make the right choices when growth stocks were being broadly sold off and capital flows reversed, moving from small into large caps.
- **Quarterly reports signal better earnings**
  We see signs that corporate earnings have bottomed out and are on their way up after a long period of stagnant earnings. US quarterly reports provided many upside surprises. We are sticking to our long-term positive outlook on equities, with a focus on Europe and Asia.

EMERGING MARKETS ARE GETTING THEIR REVENGE



Source: Bloomberg

Emerging markets in general have performed more poorly than developed markets for a number of years. However, in 2014 new stock market trends are developing with respect to different countries, sectors and styles. During the spring, India and Brazil served as engines for EM equities, while this summer China and other Asian markets climbed aboard the same train, with good share price increases as a consequence.

OVERALL, THE WORLD'S STOCK MARKETS have risen just over 14 per cent in Swedish kronor and 6 per cent in local currencies so far in 2014. India tops the list, but Brazil and the broad Standard & Poor's 500 Index in the US have also performed well. Equities in Russia and Japan have generated negative returns. During the summer, there were some headwinds in Europe, whereas stock markets in China, elsewhere in Asia and Brazil were up sharply. Signs that the economy is gaining momentum in Asia seem to have convinced investors, while European macroeconomic statistics have created some uncertainty. As a result, emerging markets have generated better returns than developed markets this year, after having performed more poorly for an extended period.

The stock market showed great resilience during the summer, ticking upwards despite geopolitical tensions in Ukraine, Gaza and Iraq. Nor did concerns about the Portuguese banking system and questions surrounding the US Federal Reserve's future interest rate policy cause investors to retreat. The outcomes of geopolitical conflicts are still uncertain, and people should keep in mind that what happens in trouble spots could pose a threat to the strong risk appetite now prevailing.

Are earnings gaining momentum?

Overall corporate earnings are expected to grow by 7 per cent this year and 11 per cent in 2015. Expectations are accordingly revised downward from May, when 9 per cent growth for 2014 was forecast. Fortunately, the quarterly earnings reports presented in July indicate that corporate earnings have bottomed out and are on their way up after a long period of stagnant estimates. One positive sign is that US companies had their best reporting season since 2011, with almost 70 per cent exceeding expectations. Global equities are valued at a price/earnings ratio of 15 for 2014, which is high compared to the historical average. US equities appear to be most expensive, with a P/E ratio of just over 17, while stock markets in Europe and Japan are cheaper. We have thus overweighted European companies in our portfolios. EM equities, mostly in Asia, are still cheapest; China and Russia stand out with the lowest P/E ratios in the world. However, investors should be cautious about Russia, due to geopolitical turmoil and because Russian companies are struggling with shrinking profits. In China, prospects look brighter and earnings per share are expected to grow by 9 per cent this year and almost 12 per cent next year.

Hard for asset managers to navigate this year

After a strong 2013, when active management generated profits for market players, 2014 has been tougher, especially for fund managers in Europe, who have had a hard time outperforming the index. Stock markets continued their upward trend, but beneath the calm surface, investors were rotating out of positions and themes that did well last year. We first saw this in the US, where shares in the biotech and IT sectors were broadly sold off in February. Profit-taking spread to Europe during the spring, expressed in a slightly different way. In Europe, active investors had been overweighted towards a recovery in the domestic economy (small caps) and underweighted in companies with EM exposure (large multinationals). This theme was reversed, with small and mid caps being sold in favour of large caps. Many active funds were left in the dust by these massive shifts.

Positive outlook for equities

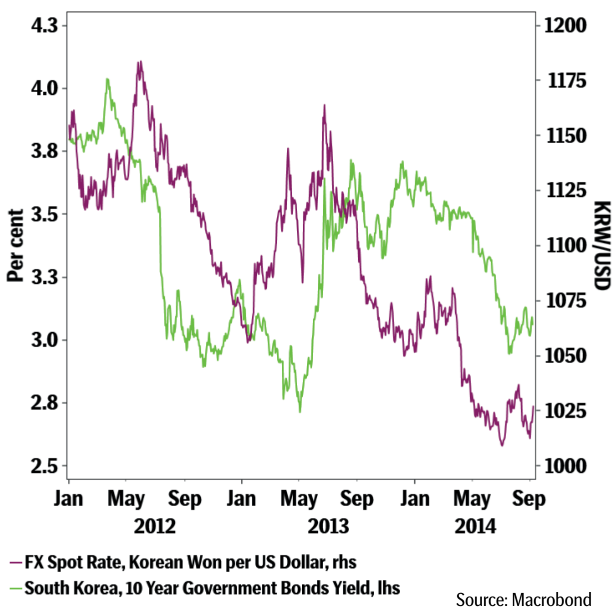
Strong macroeconomic data this summer confirmed that growth will probably gain momentum, especially in the US and China. Sustained loose monetary policies and falling government bond yields are leading us to stick to our long-term positive outlook for equities relative to other asset classes. EM equities, especially in Asia, should benefit from increased global growth and trade. We believe that the euro zone economy will provide upside surprises, helped by a weaker currency and the impact of structural reforms. We foresee an exciting autumn in the world's stock markets, and there is a good chance that we will gradually increase our risk exposure before year-end.

REGION	WEIGHT*	REASONING
Globally	1 2 3 4 5 **6** 7	Global equities will enjoy continued support from positive macro data and increased growth, which will gradually lead to higher corporate earnings. Higher P/E ratios and share prices will require upward-revised earnings forecasts and better performance; we are seeing early signs of this in quarterly earnings reports.
Europe	1 2 3 4 **5** 6 7	After the summer lull in European stock markets, we see potential for upside surprises. Euro zone purchasing managers are optimistic, and fiscal policy is providing support. We are overweighting Europe in our portfolios, since valuations and earnings growth look attractive compared to the US. Companies are cost-effective and competitive and will benefit from weaker currencies.
US	1 2 **3** 4 5 6 7	Macro data continue 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	Increased global growth will benefit emerging markets. Low valuations and high long-term earnings growth are attractive. Positive macro data and earnings forecasts, along with less political turbulence, will provide stability. We prefer Asia, including China.
Japan	1 2 3 **4** 5 6 7	Earnings forecasts are high, and earnings are being revised upwards, but from low levels. A weaker yen has provided support. Japanese stock market performance will depend on whether fiscal stimulus measures can be fully implemented or not.

** "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.*

Central banks take divergent monetary paths

- **Different macroeconomies, different monetary policy decisions**
  Signs of a faltering economy and clear risks of undesirably low inflation are giving the European Central Bank (ECB) and the Bank of Japan reason to expand stimulus measures and may persuade Sweden's Riksbank to lower its key interest rate to 0.15 per cent this autumn, whereas a strong economy and the absence of low-inflation problems mean that the US Federal Reserve and the Bank of England will start raising their key interest rates in 2015.
- **Record-low government bond yields in Europe could fall even further in the short term**
  European government bond yields have hit record lows as a result of what the ECB has done and is expected to do, as well as due to a surprisingly weak euro zone economy and greater investor interest in government bonds following a rise in geopolitical risks. New lows could occur in the short term, but if the ECB's policies succeed, yields should once again start to rise.
- **A turbulent summer for the high yield corporate bond market**
  In July and early August, money poured out of high yield bond investments, causing a rise in yields and a fall in prices. The factors triggering this movement were a decline in risk appetite when geopolitical tensions escalated, Fed Chair Janet Yellen's words of warning about bubbles and profit-taking after a long period of high returns.



Source: Macrobond

PROSPECTS OF STRONGER CURRENCIES AND HIGHER YIELDS IN EMERGING MARKETS

In the short term, EM currencies may fall somewhat, while EM bond yields may fall/bond prices may rise a little. A bit further ahead, it looks as if the situation may reverse – stronger EM currencies as key interest rates in EM countries are raised, combined with rising bond yields as the yields on US and European bonds climb. The chart shows the example of South Korea, including 10-year government bond yields and the exchange rate of the won against the US dollar.

THE MAJOR CENTRAL BANKS ARE all at a crossroads, and SEB predicts the following:

The **Bank of England** (BoE) and the **Federal Reserve** (Fed) will opt for normalisation. In the BoE's case, this means keeping the ceiling on its asset purchases at GBP 375 billion and hiking the key interest rate for the first time in February 2015 in response to an unexpectedly strong British economy. The Fed's policy choice means that its monthly bond purchases (USD 25 billion at this writing) will end in October, with the US central bank then raising its key rate in April 2015 – a tightening measure in response to high growth, a stronger labour market and gradually rising US inflation.

The **European Central Bank** (ECB) and the **Bank of Japan** (BoJ) will instead choose the opposite monetary policy path. Key interest rates in the euro zone and Japan look set to remain unchanged at least until 2017, while other types of stimulus measures will be launched.

The ECB launched a forceful stimulative package in June, including interest rate cuts and new long-term loans to commercial banks, followed in September by further rate cuts and a decision to launch a programme for purchasing asset-backed securities (ABSs) and covered mortgage bonds in October. But the risk of deflation at least in parts of the euro zone and falling inflation expectations, plus unexpectedly weak macro data, suggest that the ECB could also introduce a large-scale government bond-buying programme in the spring of 2015.

The BoJ has been a large buyer of all sorts of Japanese financial assets: from government bonds to corporate bonds and equities. This is the "first arrow" in the economic policy package known as Abenomics. The "second arrow" is fiscal stimulus. But structural reforms (the "third arrow") have been delayed, and the list presented by Prime Minister Shinzo Abe this summer was short on details. As a result, and given the flagging Japanese economy as well as difficulties in pushing up the underlying rate of inflation, there is reason for the BoJ to expand its bond purchases.

Government bond yields on both sides of the Atlantic rose last year, but so far in 2014 they have fallen – especially in Europe. The main drivers behind plunging European yields are new stimulus measures implemented or expected from the ECB, downside economic surprises in the euro zone and increased demand for safe government securities in the wake of escalating geopolitical risks. The consequence has been record-low government bond yields in countries such as Germany, France, the Netherlands and Spain.

In the short term, these yields could reach new lows if the market remains focused on possible ECB government bond purchases and the risk of deflation. But since the ECB has managed to get the market to start including higher euro zone inflation rates in its calculations, government bond yields will probably head higher. Judging from experience with the Fed's quantitative easing (QE) programme, this may very well happen at the same time that the ECB rolls out its bond purchases. Our main scenario is that 10-year German government bond yields will rise by over 0.6 percentage points to the end of 2015, while yields on their US counterparts will rise by 0.8 percentage points.

In late June and during July, market concerns about high yield (HY) corporate bonds intensified following increased geopolitical risks, an announcement by Fed Chair Janet Yellen about price bubbles in the HY market, and profit-taking after many years of tremendous gains for HY investments. But by all indications, the summer's dramatic HY market events were a correction, not the beginning of a lengthy bear market.

Fundamental factors such as bright economic prospects, the continued good financial health of companies and the low percentage of corporate bankruptcies are now bolstering the HY market. So there is still good potential in the short term as yield gaps between HY and government bonds again narrow. In 2015, conditions for HY bonds will deteriorate when the Fed and the BoE begin interest rate hikes and government bond yields on both sides of the Atlantic gradually rise. That means return expectations for HY investments should be set rather low over a slightly longer time horizon.

ASSET TYPE	WEIGHT*	TACTICAL EXPECTED YEARLY RETURN		RISK	
		SEK	EUR	SEK	EUR
Treasury bills	**1** 2 3 4 5 6 7	0.2%	0.0%	0.1%	0.3%
Government bonds	**1** 2 3 4 5 6 7	1.4%	-0.4%	4.6%	4.5%
Investment grade corporate bonds	1 **2** 3 4 5 6 7	1.8%	1.5%	2.4%	2.4%
High yield corporate bonds	1 2 **3** 4 5 6 7	5.0%	4.6%	4.6%	4.6%
Emerging market debt	1 2 **3** 4 5 6 7	6.6%	6.6%	9.5%	9.5%

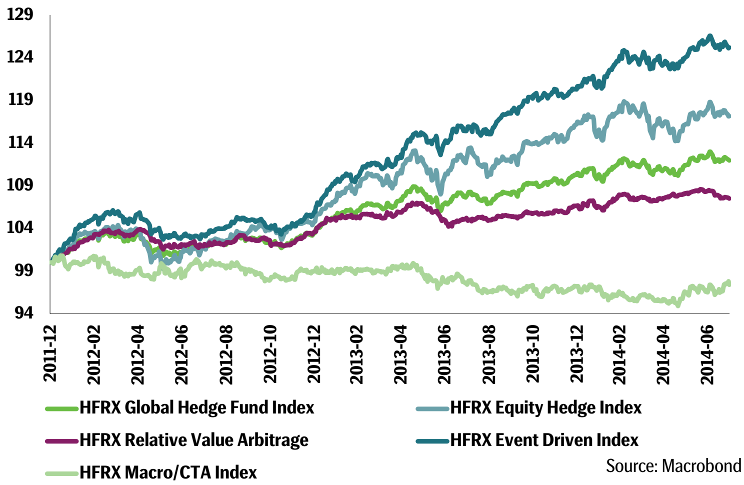
Source: SEB

** "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.*

Hard to navigate without stable market trends

- **Strategies with a fundamental value approach "a tale of two cities"**
  In the US, fundamental managers recovered quickly after the adverse impact of sector rotation in March. For European managers, the market has remained hard to navigate. We believe a bottom is near and foresee a favourable alpha environment on both sides of the Atlantic in the long term.
- **The number of corporate transactions is rising**
  Companies have large cash holdings and acquisition activity, along with share buy-backs and dividend payments, is now on the rise. Event-driven strategies stand to benefit from this trend. One caveat is that investors have increased their allocations to these strategies in anticipation of higher acquisition volumes.
- **Stable trends are beneficial**
  Trend-following strategies have been adversely affected by the clear "risk on/risk off" behaviour that has dominated the market over the past few years. The market is then driven by a smaller number of factors, which means a low degree of diversification for CTA strategies. We now see somewhat better risk diversification in these strategies, which is a positive change.

EVENT-DRIVEN ON TOP, TREND-FOLLOWING CTA STRATEGIES STILL AT BOTTOM



Source: Macrobond

Event-driven strategies and strategies linked to stock market risks continue to show the best performance. CTA trend-following strategies have continued to have a tough time, since there have been substantial swings in the risk appetite of market players.

TODAY, HEDGE FUNDS MUST BE VIEWED in light of the overall market climate we are now in. Bond markets are basically generating no returns, and many hedge funds have risk levels on a par with the bond market. That means, from a portfolio perspective, that hedge funds are fulfilling a meaningful function at somewhat lower return levels than we have become accustomed to in recent years.

Yields and interest rates are very low, since central banks are so forcefully controlling liquidity and yield curves globally. In practice, this makes conditions very difficult for hedge funds that are yield-based; there are essentially no yields on which to base activity. From that perspective, the small upward movement in US bond yields in recent weeks is positive.

Equity long/short

Hedge funds that accept some degree of underlying market risk are in a good phase. Our choice when we invest in this type of strategy, which justifies having them in our portfolios, is that they should have better risk management than the market in general. They should not decline to the same extent as the market. The rule of thumb is usually 60/30 per cent, 60 up and 30 down. In this type of strategy, the underlying market determines returns, and conditions improve if trends are stable. The degree of transparency increases and pricing is better. Asset managers who systematically eliminate the underlying market risk have in many cases experienced a more difficult phase. There could be a number of reasons, but one is that it has been hard to assess the economic cycle and the traditional pattern has not been repeated. Momentum has been too slow, which has meant holdings that "should" have performed well have not done so. Instead the focus has continued to be on those parts of the market that have benefited from extreme central bank policies. Strategies are continuously being reshaped, and as the market and economic cycle normalise, this kind of manager should generate returns. Looking ahead, a normalisation of monetary policy and some economic upswing would be positive and would produce more normal market conditions.

Relative value arbitrage

This strategy closed the second quarter with an increase. In this segment of the hedge fund market, central bank policies have had a strong impact. Performance has been subdued. Pricing in the bond markets plays a significant role. Another factor is that parts of the stock market have also been priced like bonds and not as they would be in a normal economic cycle. This pattern has made it difficult for many managers to generate returns. Central banks continue to keep interest rates down. The ECB has sharply expanded its stimulus programme, since there are significant concerns about growth and ongoing problems in the euro zone. That makes the need for supportive policies even greater. One consequence is that yield gaps between different segments of the bond market are extremely small, thus reducing the potential to generate returns. Conditions in the credit market are better today, and we also see good potential for returns since we expect a normalisation of the extreme conditions for central banks, although this could take time.

Event-driven

A significant share of today's lending to companies goes to acquisitions and share buy-backs – transactions that change the capital base of companies and lead to new balance sheet structures. This is the natural territory of event-driven funds. We now have a climate that is favourable for this type of hedge fund manager. The event-driven strategy was also a winner during the second quarter. We have had a positive view of this strategy for a rather long time, and our arguments for it still hold, perhaps to an even greater extent. Merger and acquisition activity is on the rise, both in the US and Europe. We also see a pattern of US companies "emigrating". The event-driven strategy was a winner in 2013 and has clear potential to be a winner in 2014 as well.

Macro /CTA

The second quarter ended positively for trend-following strategies, pushing their returns for 2014 above break-even. During the second quarter, a number of trends stabilised to the benefit of CTA strategies. However, these trends have been volatile, disrupting trend-following strategies. Geopolitics, central bank actions and policy announcements have continued to have an adverse effect on macro strategies. Sector rotation to value equities and movements between emerging and developed markets have also factored into this, at the same time as we saw significant currency movements. These strategies provide potential diversification and may thus merit a place in investor portfolios.

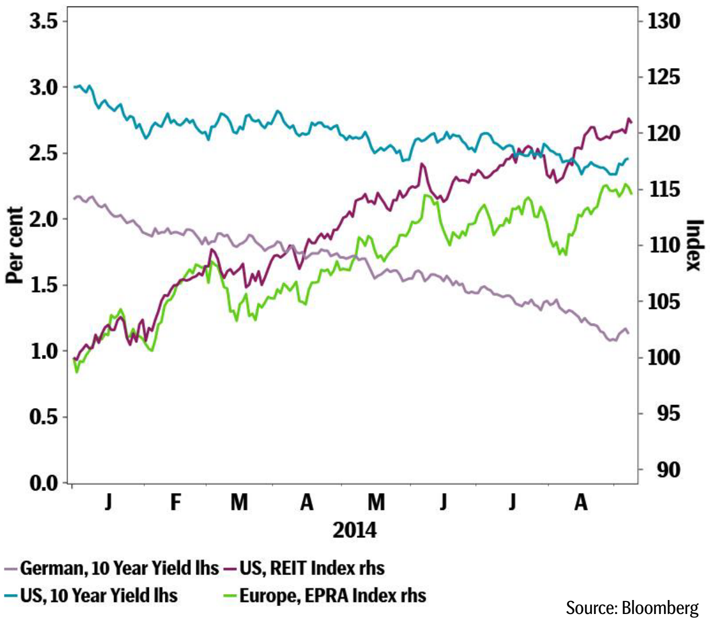
STRATEGY	INDEX	PERFORMANCE % (USD)					
		JULY 2014	Q2 2014	2013	2012	2011	2010
Global hedge	HFRX Global Hedge Fund Index	-0.9	0.6	6.7	3.5	-8.9	5.2
Equity hedge	HFRX Equity Hedge	-1.6	0.0	11.1	4.8	-19.1	8.9
Relative value	HFRX Relative Value Arbitrage	-1.1	0.6	3.0	3.6	-4.0	7.7
Event-driven	HFRX Event Driven	-1.0	1.6	13.9	6.0	-4.9	2.0
Macro	HFRX Macro	0.5	0.3	-1.8	-1.0	-4.9	-1.7

Source: SEB

Rising interest rates not necessarily bad

- **Major differences between different sectors of the REIT market**
  The REIT market as a whole seems relatively expensive, but there is great variation between sectors. REITs for multi-family dwellings and shopping centres are trading at discounts to net asset value.
- **Stimulative monetary policy and economic growth continue to buoy the market**
  Strong US economic growth gives the Federal Reserve a reason to end its bond purchases this autumn. Meanwhile, weaker economic growth in the euro zone points towards further stimulus from the European Central Bank.
- **The search for returns still bodes well for secondary markets**
  Ever-higher valuations in primary markets are forcing investors to take on higher risk in the search for returns. Valuations in many secondary markets, for instance in southern Europe, provide some yield potential.

FALLING GOVERNMENT BOND YIELDS HAVE BENEFITED THE REIT MARKET



Source: Bloomberg

Since the turn of the year, the broad REIT market in both Europe (EPRA Index EUR) and the US (REIT Index USD) has turned in an excellent performance, benefiting greatly from falling government bond yields. The trend in the Asian REIT market has been in line with the US. In terms of valuations, the potential appears to be greater in Europe, where the trend so far this year has not been as strong.

SINCE THE TURN OF THE YEAR, the market for listed real estate investment trusts (REITs) has generated excellent returns. Fundamental economic growth, but above all the continued decline in government bond yields, has contributed to their strong performance this year. In the last issue of *Investment Outlook,* we described the negative correlation between broad REITs and government bond yields. Despite periods of negative correlation, rising yields need not constitute a threat as long as growth continues.

Although the broad REIT market as a whole looks relatively expensive compared to underlying net asset value (NAV), there is still a lot of variation between different sectors in this asset type. For instance, REITs for multi-family dwellings and shopping centres are trading at discounts whereas health care-related properties are trading at premiums to NAV.

After a volatile summer, dominated by geopolitical storm clouds, the focus has once again shifted to central banks' stimulative monetary policies. The differences between the euro zone and the US seem to be growing, as indicators repeatedly point to a stable recovery in the US while various countries in the euro zone are wrestling with stagnation and deflation risks. Increasingly clear signals of an improved US labour market have caused investors to start worrying about when the Federal Reserve may begin raising its key interest rate. SEB's forecast is an initial rate hike by April 2015.

The picture is different in the euro zone, where the European Central Bank decided to further lower its key interest rate following its latest policy meeting. It also announced a plan to purchase asset-backed securities (ABSs) and covered mortgage bonds. This, in turn, has been reflected in gaps between US and German government bond yields. Yields on 10-year German bonds fell below 1 per cent in late summer, while yields on US Treasuries levelled off at around 2.3 per cent. The forecast for the second quarter of 2015 is 1.4 per cent for German 10-year bonds and 2.8 per cent for their US counterparts. In other words, rising yields are in store, but the yield gap will probably persist.

This low-yield, low-interest rate environment has long forced investors further out on the risk scale in the search for returns. Low risk-free returns have benefited assets such as equities, corporate bonds and real estate investments. US economic growth has gradually pushed up demand for multi-family dwellings and commercial properties, which have performed better than the US stock market. But higher prices have contributed to ever-lower yields. When REITs generate lower returns than a 10-year government bond, their prices usually fall. That is not the case today, especially not in Europe. But if government bond yields bounce back as they did in summer 2013, there is a risk of a price correction.

Given the previously noted interest rate sensitivity of this asset class, especially REITs, future rate hikes are a risk if they are implemented too quickly. The Fed is expected to end its bond purchases this autumn and is now considering when the US labour market will be ready for an initial rate hike. Key interest rates in both Europe and the US will probably remain low for a long time to come. Economic growth and a sustained stock market rally would mean continued favourable conditions for the REIT market. Yields and interest rates are expected to rise, especially in the US, during the autumn and into 2015, but as long as these movements are cautious, the risk of sudden corrections in the REIT market is limited. The ECB's recent unexpected rate cut suggests a lengthy period of low interest rates and yields in Europe, which is beneficial to REITs.

Notable trends in the real estate market, driven by changes in consumer behaviour, have been increased consolidation in the retail sector and a continued high level of merger and acquisition (M&A) activity. Restructurings of logistics chains in the retail sector have driven the demand for modern warehouse facilities, while there is still great interest in hotel investments (dominated by private equity investors).

The transaction market for commercial properties has not seen such high levels since 2007. Total investment volume during the first half of 2014 was up 27 per cent compared to the same period last year, which can be seen as a sign of good health. The search for returns still bodes well for secondary markets, where prices – for instance in parts of southern Europe – still offer an attractive yield. Sustained economic growth combined with gently rising interest rates are excellent conditions for REITs. Rising interest rates are not necessarily bad, but the main threat continues to be those factors that could lead to sharp movements in interest rates and yields.

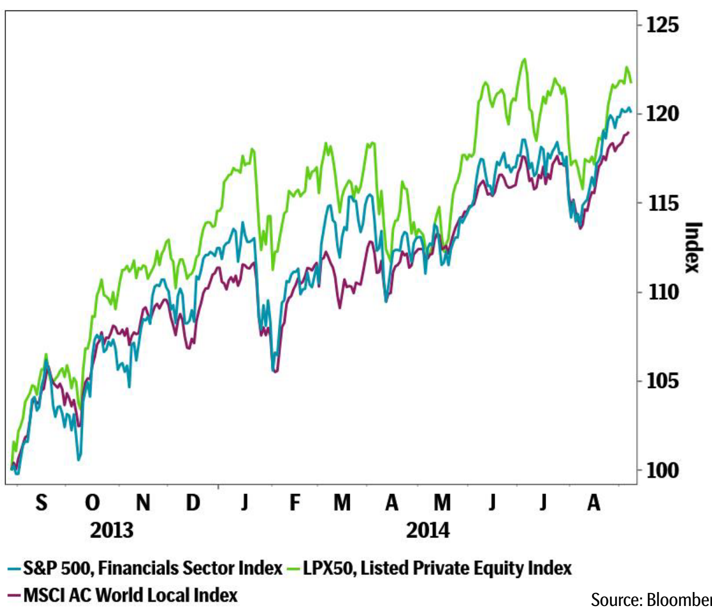
Valuations challenge investment climate

- **Cash holdings rise due to a shortage of companies to invest in**
  High valuations have made it increasingly hard for private equity firms to find attractive investments. These difficulties have led to increased cash holdings.

- **Reinvested dividends also increase cash holdings**
  Realised gains distributed to owners tend to be reinvested in new funds, which is another factor contributing to the large cash holdings of private equity funds.

- **Potential for a sustained positive trend**
  Government bond yields will rise in the long term, but if this occurs alongside improved growth and increased earnings, conditions are in place for sustained good return potential for private equity.

PRIVATE EQUITY IS OUTPERFORMING WORLD STOCK MARKETS



Source: Bloomberg

Over the past year, the broad index for private equity (LPX50 Total Return in EUR) has generated a return of over 20 per cent, but increased volatility combined with geopolitical turmoil brought a sharp decline at the end of the summer.

IN PREVIOUS ISSUES OF *INVESTMENT OUTLOOK*, we have noted how the private equity (PE) market has benefited from stimulative central bank policies. Growing risk appetite has fuelled the transaction market, where the number of investments that PE firms have sold is on the rise. The low-interest rate/yield environment has long meant that investors have been forced further out on the risk scale in the search for returns. Increased interest in risk assets has pushed up prices of both equities and bonds. In the credit market, spreads between corporate and government bonds have narrowed, while valuations in the stock market look increasingly stretched in a number of regions. High stock market valuations have made it attractive for PE firms to sell mature portfolio companies, for instance through initial public offerings (IPOs). On the other hand, rising valuations have made it difficult to find attractively valued companies to invest in.

The opportunity to sell mature investments and thereby realise potential profits has meant that ever more capital has been distributed to unit-owners in PE funds. In December last year, a new record was set in annual dividends for private equity funds. Dividends in 2013 were almost 50 per cent higher than total dividends in 2012 and are probably a major source of the capital inflow to private equity funds, since a significant proportion of the capital distributed is apparently reinvested in this asset class. This distribution of realised gains has also helped bring about a more accurate valuation of private equity firms, which is why discounts to net asset value, once close to 30 per cent, are now essentially zero.

So far this year the trend for listed private equity, measured by the LPX50 Total Return Index in EUR, is in line with the broad stock market as measured by the MSCI AC World Index in local currencies. Despite periods of sharp fluctuations in the market, PE volatility has not been significantly higher. Over the past year, the trend for listed private equity has been stronger than that of the broad stock market and broad financial indices, measured by the S&P Financial Index.

While the capital in PE funds continues to grow, the percentage of capital in these funds that is not invested has also increased, setting new records. Non-invested capital has risen by 8 per cent since the turn of the year. One reason for the swelling cash holdings in PE funds is the large inflow of capital, but it is also likely that ever-increasing valuations have gradually reduced the number of attractive investments. This capital cannot remain uninvested; sooner or later it will have to generate a return, which is one reason to believe that prices will continue to rise in the stock market. In the search for attractive investments, many funds will be forced to settle for "next best" investments. Selecting PE fund managers is thus especially important. A desirable strategy is to receive a share of excess returns without downside risks being too great.

High valuations, especially in the US, have meant that a growing number of PE firms are looking for attractive investments in "frontier markets", such as developing countries in Africa. In Europe, the number of investments backed by PE funds continues to grow, while the number has fallen in both the US and Asia. In China, the authorities have reduced the administrative burden for domestic PE investments, so there should be increased opportunities in that country over the long term. Less transparent valuations can also be found in more complex investment cases, such as carve-outs, where part of a company is divested and managed separately. There are also signs that a growing number of niche PE funds have emerged, including in the agricultural and energy sectors.

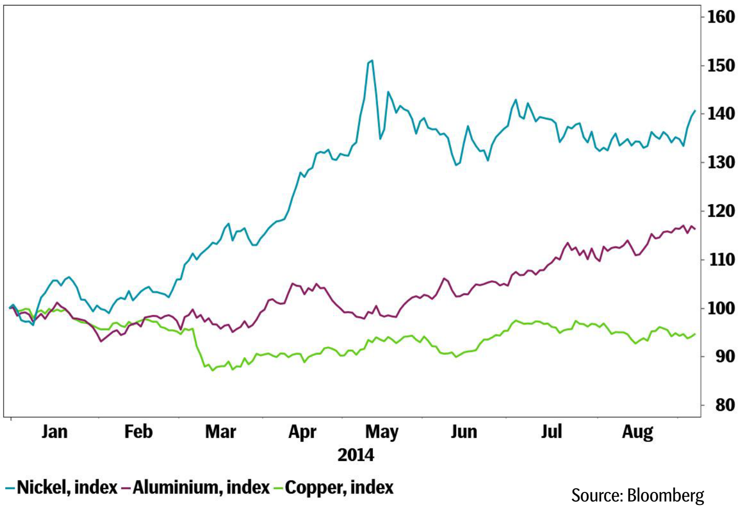
It looks as if the negative impact of reduced monetary stimulus in the US could be offset by additional supportive measures from the European Central Bank. The greatest risks that might trigger increased volatility and an abrupt trend reversal this autumn are sharp movements in interest rates/yields and escalating geopolitical turmoil. Interest rates will eventually rise in Europe and the US, but as long as increased economic growth bolsters valuations, there is return potential. The greatest challenge for many PE firms will be to invest their growing cash holdings in a market with such high valuations. The opportunities are there, but it takes skilful asset managers to identify them.

No sharp commodity price movements

- **Excess supply weighing down oil prices**
  Expectations of lower oil production in Saudi Arabia in order to achieve market balance have not been realised. Global demand has increased less and supply more than forecast. There is now excess supply in the market, with rising inventories and lower prices as a consequence.

- **Prices have been too low for too long**
  Low aluminium prices have led to production shutdowns and therefore less supply. High electricity prices due to the drought in Brazil have also contributed to the current market shortage. This imbalance will probably persist for about a year and help keep prices up.

- **More petrol-fuelled cars boosting palladium prices**
  Precious metals are not expected to see any major price movements over the next year. The strikes in South Africa were not enough to boost platinum prices. However, increased demand for petrol-fuelled cars combined with concern about developments in Russia has led to lower inventories and higher prices for palladium, a precious metal we believe has some potential.



Source: Bloomberg

LOW PRICES OVER A LONG PERIOD HAVE CAUSED ALUMINIUM PRODUCERS TO ACT

Aluminium prices have shown a relatively sharp increase since February. Following shutdowns in production combined with increased demand, there is now a shortage in the aluminium market, which has affected prices. This situation is expected to persist for about a year. The effect of Indonesia's ban on nickel ore exports can also be seen clearly in the chart. We believe there is still potential for rising prices.

ALTHOUGH WE EXPECTED OIL SUPPLIES to rise faster than demand in 2014, the imbalance has proved greater than anticipated, since demand has increased less than we forecast earlier. This is mostly due to a slightly weaker global economy and to a sharper supply increase because of larger production in Libya and the US. The increase in demand during the first half was the weakest since 2012. We had also expected Saudi Arabia to adjust its production to keep the market in balance, especially since that country was producing almost 10 million barrels a day, a 30-year high. Yet the country has continued production at an unchanged pace; the result has been rising global inventories six months in a row and oil prices below our forecasts. We now expect oil to trade at USD 105/barrel this autumn, or USD 5 lower than our earlier forecast. We expect prices of around USD 100/barrel a year from now, with a downside risk if Saudi Arabia does not adjust its production. The upside risk lies mainly in the possibility of turmoil in southern Iraq, where the bulk of that country's oil production is located.

In the May issue of *Investment Outlook*, we noted how Indonesia's export ban on nickel ore (20 per cent of global production) had a strong impact on the price trend last spring. During the summer, nickel prices fell somewhat. Despite the export ban, global inventories have begun to rise. Russia is the world's third largest nickel exporter, and its exports have not yet been affected by the current turmoil. In our assessment, the shortage in the nickel market will lead to higher prices next year.

While **copper** prices have risen since spring, they are still lower today than at the turn of the year. The copper market is currently sending out unclear signals, with the price trend being relatively weak, which is reasonable for a market with excess supply. Meanwhile global inventories are at their lowest levels since 2008. Inventories in China have also shrunk. Demand from China is critical to the price trend (the country consumed 47 per cent of global production in 2013). We expect copper to trade at close to today's prices a year from now. Copper prices need to be at around USD 6,000/tonne (current price about USD 6,900/tonne) in order to achieve profitability on new mining investments, so the risk of a large, long-lasting price decline should not be that great.

High **aluminium** inventories over a long period have resulted in low prices, unprofitable production and smelting plant closures. About 50 per cent of the production cost of aluminium is electricity, so the severe drought in Brazil (which has led to higher electricity prices) caused 36 per cent of the country's aluminium production (normally 1.3 million tonnes) to shut down during the third quarter. Combined with increased aluminium consumption, this has led to a shortage in the market and rising prices (up 25 per cent since February). We believe this shortage could last for several years and thus expect somewhat higher prices next year.

Our earlier **gold** price estimate for 2015 was USD 1,200/oz. Since then, in the absence of inflation expectations, forecasted future interest rate hikes (the alternative cost of physically owning gold) have been postponed. As a result we now expect gold to trade at USD 1,250-1,300/oz in 2015, which is the current level.

After a five-month strike by 70,000 workers in South Africa's mines, the parties reached an agreement in June. The fact that **platinum** prices did not increase to any great extent even though 70 per cent of global production normally takes place in South Africa indicates that inventories were higher than expected. While some production is being shut down due to lack of profitability, we believe the market is in balance and therefore expect platinum prices to remain relatively unchanged. A surprisingly strong European economy could potentially change this outlook, since a significant share of platinum production is used for catalytic converters in diesel-fuelled cars, which are sold mostly in Europe. For **palladium**, which is used in catalytic converters for petrol-fuelled cars, the picture is somewhat different. Inventories are falling and prices have risen, driven by growing demand for petrol-fuelled cars (in China and the US) and as a result of the turmoil in Russia (which accounts for almost 45 per cent of global production). However, we do not expect any major price increases.

Prices of **agricultural products** rose last spring, both as a consequence of the Russia/Ukraine crisis – Ukraine is the sixth largest exporter of wheat and the fourth largest of maize (corn) – and due to fear of the El Niño weather phenomenon. This year's El Niño did not have a strong impact, and Ukraine's exports did nicely, so prices retreated. Assuming no weather disruptions, we believe that prices of agricultural products will be somewhat higher a year from now.

ASSETS	WEIGHT*	REASONING
Energy	1 **2** 3 4 5 6 7	Stronger supply and weaker demand in the oil market than forecast, combined with continued record-high production from Saudi Arabia, weighed down prices during the first half of the year. We expect oil to trade at USD 100/barrel a year from now.
Industrial metals	1 2 3 **4** 5 6 7	We expect Indonesia's export ban on nickel ore to lift prices a bit further. Low aluminium prices over a long period have led to production shutdowns and rising prices.
Precious metals	1 **2** 3 4 5 6 7	In the absence of inflation expectations, we expect gold to trade at around current prices a year from now. Platinum prices did not rise despite strikes in South Africa. Now that the strikes are over, hopes are focusing on the European economy. Global palladium inventories are falling and production is being disrupted by turmoil in Russia.
Agricultural	1 **2** 3 4 5 6 7	After a relatively long period of falling prices, there is now some potential for an upswing over the next year.

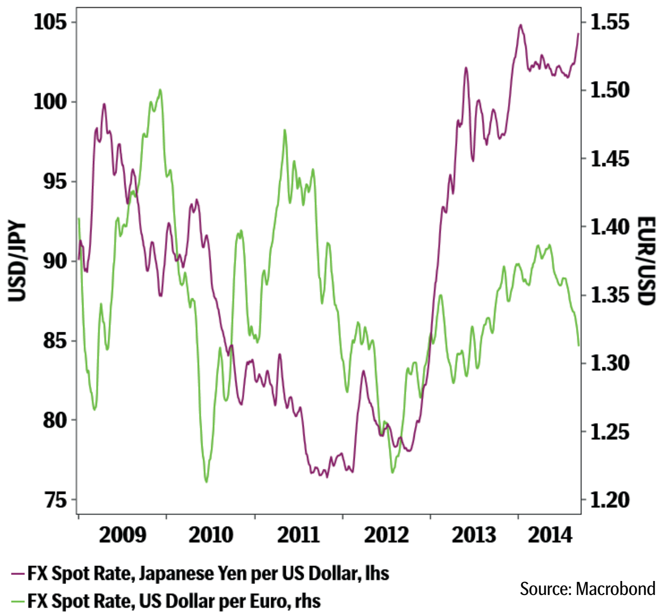
** "Weight" indicates how we currently view the asset class as part of a portfolio. Level 4 is a neutral stance. These weights change continuously depending on our tactical market outlook and may therefore differ from our long-term strategic outlook for the asset.*

Monetary policies driving FX markets

- **Different monetary policy paths result in different currency rates**
  The combination of a strong economy and prospects that the Federal Reserve will begin tightening its monetary policy in the spring of 2015 is helping push up the US dollar (USD) against the euro and the yen, which are weighed down by flagging economies and by the prospect of future monetary stimulus packages in the euro zone and Japan.

- **Risk of post-election uncertainty and further rate cut will weigh down SEK this autumn**
  So far during 2014, the Swedish krona (SEK) has been a loser. Growth in Sweden has been unexpectedly slow, and the Riksbank has cut its key interest rate to 0.25 per cent. The risk of great uncertainty after the September 14 parliamentary election and another repo rate cut this autumn should further weaken the krona, which may nevertheless recover somewhat in 2015-2016.

- **After a bumpy ride, a number of EM currencies look set to appreciate in 2015**
  Emerging market (EM) currencies have been on a roller coaster since the turn of the year. This summer's weakening trend could continue for a while, but in 2015 improved economies and interest rate hikes are in store for parts of the EM sphere – especially in Asia, where several currencies may appreciate against the USD. However, prospects have dimmed for the currencies of Brazil, Russia and South Africa.



Source: Macrobond

A STRONGER DOLLAR IS LIKELY

After a few volatile years for the US dollar against the euro and Japanese yen, SEB now foresees a clear dollar appreciation in 2014-2016. This is because the economic outlook appears much brighter in the US than in the euro zone and Japan, and because of the ongoing shift in Federal Reserve policy towards monetary tightening. Meanwhile the European Central Bank and the Bank of Japan look set to expand their stimulus measures further.

SO FAR THIS YEAR, CURRENCIES IN HIGH INTEREST-RATE countries and/or countries with central banks that have announced plans for interest rate hikes are among the winners. That group has included commodity currencies in particular. If monetary policies and policy expectations continue to drive the foreign exchange (FX) market, our conclusion is that the **US dollar** (USD) should be included in the strong group going forward, rising in value against the euro (EUR) and Japanese yen (JPY), among other currencies.

The Federal Reserve (Fed) is now tapering its bond purchases in order to end them this autumn and will probably begin raising its key interest rate in the spring of 2015. Meanwhile the European Central Bank (ECB) and the Bank of Japan do not appear likely to introduce any interest rate hikes until 2017 at the earliest, and they could both also launch other monetary stimulus measures over the next six months (see the "Fixed income" section).

One difficulty in analysing what will happen with the **British pound** (GBP) is the Bank of England's inconsistent communication, which this summer has repeatedly forced SEB and the FX market to adjust their forecasts of when the British central bank will implement its first interest rate hike. Our main scenario now is that the BoE will embark on its rate hikes a bit into 2015. That suggests a stronger GBP going forward both against the EUR and the JPY. However, in the short term, the September 18 referendum on Scottish independence is a major uncertainty factor.

Our forecast also shows significantly higher economic growth in Britain and the US than in the euro zone and Japan during 2014-2016, another factor favouring the British and US currencies. As for the USD vs the GBP, our forecast is that the USD will be the stronger of the two over the next few years.

As for the **Swedish krona** (SEK) and its sister currency the **Norwegian krone** (NOK), the SEK has clearly been weaker since the turn of the year. One important reason is the Riksbank's interest rate cuts since mid-December 2013, totalling 0.75 percentage points and bringing the Swedish repo rate down to 0.25 per cent. In particular, the Riksbank's surprisingly large 0.50 percentage point cut in early July dragged down the SEK, which was in last place among G10 currencies during the first eight months this year. Another reason is that Norges Bank has held back on rate hikes, leaving the Norwegian key interest rate unchanged at 1.50 per cent, although in June the bank signalled a possible cut by revising its interest rate path downward.

While the SEK gained some ground in late August/early September, the risk of great political uncertainty after the September 14 parliamentary election – combined with our view that the Riksbank will once again lower its repo rate, to 0.15 per cent in October – suggests a new round of SEK depreciation against many other currencies this autumn.

But next year and in 2016, the SEK has a chance of again appreciating against the EUR, since the Swedish economy should strengthen considerably and the Riksbank will initiate its rate hikes in spring 2016, well before the ECB (2017 at the earliest). However, the USD will get the better of the SEK and gradually become more expensive, while the Norwegian krone may become a little cheaper in terms of the SEK, since it is not as undervalued as the Swedish krona.

Many currencies in the **emerging market** (EM) sphere have been on a roller coaster ride since the turn of the year. In the short term, EM currencies may fall somewhat in value, since the gap between emerging and developed market (DM) countries for both money market rates and short-term bond yields has narrowed. There is consequently declining interest in the "carry trade" – borrowing in countries with low interest rates and investing in countries with higher rates. In 2015, the trend will reverse – EM currencies will strengthen as a growing number of EM central banks begin raising their key interest rates and many EM economies become stronger. This pattern is likely to be most evident in emerging Asian countries, where broader monetary tightening is expected in 2015.

In SEB's view, a number of Asian currencies have the potential to strengthen against the USD over the next year, especially the Indian rupee (INR), Indonesian rupiah (IDR), Singapore dollar (SGD) and Chinese yuan (CNY). As for the INR, we foresee appreciation potential mainly linked to a more robust Indian economy and hopes of economic reforms being launched as a result of the change of government in May, when the Bharatiya Janata Party (BJP) led by Narenda Modi won a majority in the lower house of parliament. In the case of the CNY, the main factor pointing towards appreciation is the prospect of record Chinese trade surpluses and extensive capital inflows.

In contrast, other currencies in the BRICS countries (Brazil, Russia, India, China and South Africa) should weaken against the USD until early autumn of 2015. The real (BRL) is being weighed down by Brazil's substantial macroeconomic imbalances, which have almost halted economic growth there, and there are few signs that adequate structural reforms will be launched after the presidential election in October. The Russian rouble (RUB) will probably weaken further as a result of the Russia/Ukraine crisis, economic sanctions imposed by the US and EU, outflows of private capital and a flagging economy. In South Africa, the rand (ZAR) is being weighed down by high inflation, a growing current account deficit, lowered GDP forecasts and the absence of labour market reforms. In hindsight, a series of key interest rate hikes by the South African central bank has failed to keep the rand from depreciating.