Investment Outlook

Slowly, but in the right direction

PRIVATE BANKING • INVESTMENT STRATEGY

DECEMBER 2014

SEB

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This report was published on December 2, 2014.
The contents of the report are based on information available before November 26, 2014.

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Slowly, but in the right direction

The world economy continues to climb further, led by the United States, while the world's central banks are expected to remain supportive of financial markets in general and riskier asset classes in particular.

"It was the best of times and it was the worst of times," read the opening words of *A Tale of Two Cities*, the literary classic by Charles Dickens. We used this quotation in the last edition of *Investment Outlook* (published in September) to illustrate the differences between the sustained upturn in the stock market and the historic decline of yields in the bond market. The quotation can also be used to illustrate what has happened in the stock market since then. A sharp decline in share prices during early and mid-October was followed by a sharp rebound. On the same theme, worries about growth have diminished and we are seeing more and more signs of economic stability. The recovery in the economy and in the world's financial markets is fragile, which is why politicians and central banks around the world seem ready to take action to support growth. Stock markets today are generally higher than in September, especially American ones, which are at or near their highest share prices ever.

The picture that we have communicated for a while includes relatively good US economic performance and a gradual normalisation of American monetary policy. The euro zone, on the other hand, is suffering from weak demand as well as weak growth and structural problems, which is why the European Central Bank is using more tools from its monetary policy kit.

Since the last issue of *Investment Outlook*, the following has also happened:

- The Federal Reserve has ended its stimulative bond purchases.
- The ECB and the Bank of Japan have launched further stimulus measures.
- The International Monetary Fund (IMF) has marginally downgraded growth expectations for 2014 and 2015. Its global growth forecast of about 3.8 per cent for 2015 now matches SEB's forecast.
- The third quarter reporting period has ended; company earnings were generally better than expected, but unfortunately there were also downward revisions in expectations of future earnings.
- The results of the 2014 stress tests of European banks were presented without major drama.
- Sweden´s Riksbank has cut its key interest rate to zero.

What conclusions does this lead to for our market view? As earlier, events are benefiting high-risk assets, especially equities. In our assessment, the prevailing rather slow economic upturn may last for quite a while longer, although its path will probably continue to be volatile, as developments in October and November showed.

In this issue of *Investment Outlook*, we take a close look at the recent stress tests of European banks. What threats and opportunities do the results point to, and what will they mean for the future? Our theme article entitled "Alternative paths for the world economy" also deals with possible future scenarios. Are we facing a new Japan-like zero growth scenario? Or are we facing "secular stagnation", which is slightly less serious? Or might we even see an unexpectedly positive trend?

In addition to these themes, the issue includes analyses of asset classes and presents our current portfolio management strategy.

Wishing you enjoyable reading,

SEBASTIAN SIEGL
Global Head of Investment Strategy

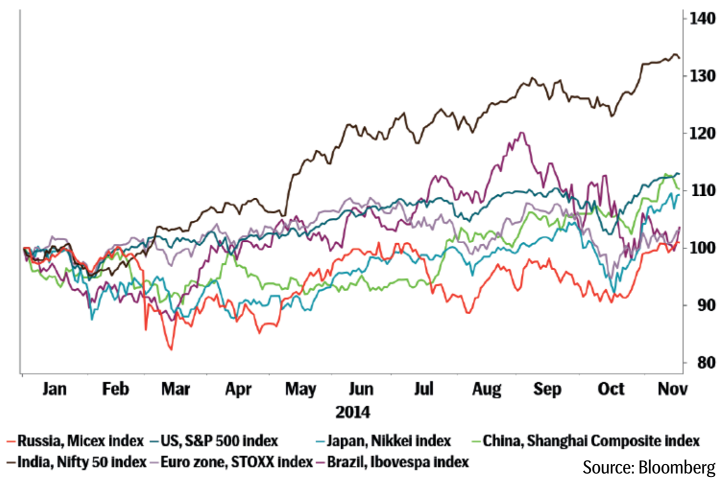
Portfolio strategy

Continued growth driving stock markets upward

Our main scenario is that 3.5-4 per cent global growth should be enough to drive stock markets higher in a stable but not especially powerful trend. Aside from economic growth, stock market performance is also being sustained by a lack of alternatives. The volatility we have seen this autumn is primarily a reflection of uncertainty about the shift in forces that are driving the market, illustrated among other things by the Federal Reserve's phase-out of supportive bond purchases. In the United States, growth by itself is expected to suffice as a market driver.

Sentiment in financial markets remains mixed. The past month saw a rebound, after the stock market slide earlier this autumn. The recovery was mainly driven by positive signals in third quarter company reports and strong macroeconomic data from the US. In Europe and Japan, central banks are also continuing to stimulate the economy. This not only contributed to the recovery during October and November, but will also be among the most important drivers in the future, since to some extent these central banks are taking over the Fed's role of supplying the world with liquidity. Assuming slightly less negative news and good prospects of economic stabilisation in Europe, the future of that region looks promising.

In addition to central bank actions, the political agenda will be important going forward. Today financial markets are coping decently with geopolitical risks, although European share prices can be said to include a certain risk premium due to developments in the Ukraine-Russia crisis. Central banks control interest rates, yield curves remain at extremely low levels and we do not foresee any decisive upward shift. What may possibly disrupt this pattern is US bond yields, which we expect to climb somewhat once the economy is moving further upward. However, this should be viewed as a positive sign of economic normalisation.



Source: Bloomberg

2014 MAY BE ANOTHER GOOD STOCK MARKET YEAR

The MSCI All Country World Index in local currencies has climbed more than 8 per cent so far in 2014. India and China (Shanghai) are the top performers, while Brazil and Russia rank last. Brazil began the year nicely but has wiped out all gains during the past three months. Euro zone macro statistics are creating some uncertainty, which is reflected in relatively weak stock market performance. In Japan, the index bounced higher after the announcement that Japanese pension funds will increase their equity allocation.

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	 11% 8%	 11% 15%	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% -	 4% -	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, measured as the OMRX RXVX Index.
Hedge funds	3%	4%	The risk and return forecast is based on the HFRX Market Neutral Index.
Real estate	5%	12%	The risk and return forecast is based on the European Public Real Estate Association (EPRA) Index.
Private equity	14%	14%	A beta adjustment of global equities (1.2), measured as the performance of the LPX50 Total Return and MSCI AC World LOC indices over the past 10 years.
Commodities	3%	12%	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.

MAIN STRATEGIES IN OUR PORTFOLIO MANAGEMENT

- **We are in a slow recovery period – valuations will be adjusted**
  The low intensity of the recovery has defied the expectations of virtually all observers, but the US is leading the world economy upward, emerging market (EM) countries are right behind it and Europe is slowly following suit. This year, low commodity prices and China's deceleration have limited activity. This is closely reflected in the pricing of the various markets, but the differences are not justified if growth – as we believe – will gradually speed up.
- **Three major economies will provide the world with liquidity**
  The US Federal Reserve is limiting its support, since it has stopped its stimulative bond purchases, but the central banks in the euro zone and Japan are prepared to take over. Now China's central bank has also demonstrated its willingness to stimulate growth. China's economic expansion has slowed, and the government wants to maintain demand. The end result is that three major central banks will supply the world with liquidity, which is positive for stock markets.
- **Euro zone investments may enter a new phase**
  There is a tendency for macro data in the euro zone not to deteriorate further. Viewed in a positive way, this signifies a gradual improvement. The cheaper euro should justify a more optimistic view of corporate earnings capacity. Expectations as expressed by share valuations are low, while US equities may be regarded as having high valuations.
- **Bond yields remain extremely low**
  World inflation remains extremely low, with a risk of deflation in some places. That plus good liquidity is resulting in today's low bond yields. We foresee no major investment opportunities here. It is interesting that US bond yields have actually started to rise as a result of better data and a tendency towards stability with regard to wages and inflation. Corporate bonds remain volatile and we continue to have a cautious approach.
- **There is a focus on foreign exchange markets – a time for competitive devaluations**
  The US dollar is enjoying a strong upturn. Differences in monetary policy between the US and practically all other countries justify continued dollar appreciation. Japan and the euro zone will pursue aggressively stimulative policies, and as a result their currencies will lose value. Given low interest rates and the relatively limited pace of economic growth, currency strategy will be important. We can foresee more and more reasons to protect ourselves against currency risks.
- **Commodity markets, especially oil, may be more important ahead**
  Low commodity prices will generally result in lower inflation pressures, in turn making it possible for central banks to provide further stimulus. Some EM countries where retail demand has been a problem should be affected. Lower oil prices will have a positive global effect on consumption, which may also improve investor sentiment.

ASSET	WEIGHT*	REASONING
Equities	1 2 3 4 **5** 6 7	Strong data from the US and improvement potential in the euro zone, assuming a weaker euro and lower energy costs. Support from further central bank stimulus measures in Europe, Japan and China.
Fixed income	1 **2** 3 4 5 6 7	Low inflation, low capacity utilisation and weaker growth signals in some places will give central banks reasons to keep key interest rates low for another while. Wider yield spreads against government bonds have increased short-term potential for credits, but rising yields in the coming year remain a risk, making short durations appear the most attractive.
Hedge funds	1 2 3 **4** 5 6 7	A stable trend will mean lower correlations, benefiting many strategies.
Real estate	1 2 **3** 4 5 6 7	Low interest rates along with strong macro data, especially from the US, will continue to benefit this asset class.
Private equity	1 2 3 **4** 5 6 7	Growth and recovery in the US economy, along with expanded monetary stimulus measures in Europe and Japan, will provide a good foundation for continued strong activity.
Commodities	1 2 **3** 4 5 6 7	After about a 30 per cent oil price decline since early summer, we believe that next year's prices will be somewhat higher than today's, although they may first become lower before they go higher. We also expect higher prices for industrial metals during 2015, as a result of supply shortages of both nickel and aluminium and future shortages in the copper market. The decline in gold prices will probably continue, while agricultural commodity prices have stopped falling.
Currencies	1 2 3 **4** 5 6 7	The US dollar is in a strong trend, and differences in monetary policy between the US and the rest of the world justify continued dollar appreciation. Japan and the euro zone will pursue stimulative policies, causing their currencies to lose value. Given low interest rates and the relatively limited level of growth, currency strategy will be important. We can foresee more and more reasons to protect ourselves against currency risks. Outlook for Q3 2015: EUR/USD, 1.17 (-5.9%), EUR/SEK, 9.10 (-1.7%); USD/SEK rate 7.78 (+4.5%).

Source: SEB

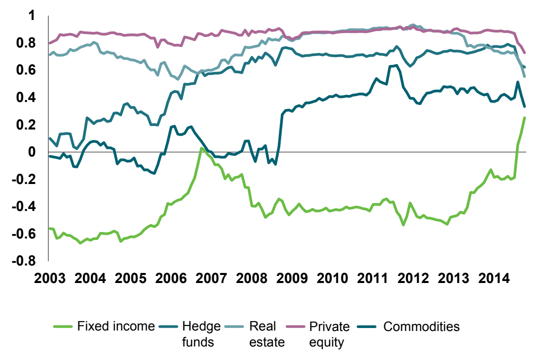
** "Weight" shows how we currently view the asset class as part of a portfolio. Level 4 is a neutral stance. These weights are changed continuously, based on our tactical market view, and may thus diverge from our long-term strategic view of an asset class. At the customer level, portfolios are tailored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

HISTORICAL CORRELATION (OCT 31, 2004 TO OCT 31, 2014)

	Equities	Fixed income	Hedge funds	Real estate	Private equity	Commodities
Equities	1.00					
Fixed income	-0.34	1.00				
Hedge funds	0.65	-0.28	1.00			
Real estate	0.81	-0.09	0.54	1.00		
Private equity	0.85	-0.28	0.69	0.85	1.00	
Commodities	0.31	-0.17	0.65	0.28	0.40	1.00

Source: SEB

ROLLING 36-MONTH CORRELATION VS. MSCI WORLD



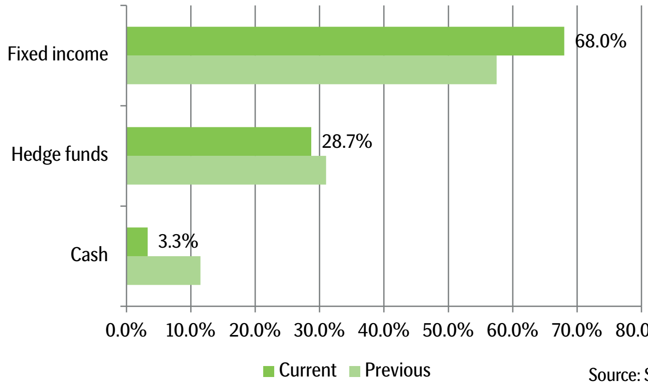
Historical values are based on the following indices: Equities = MSCI AC World EUR; fixed income = JP Morgan Global GBI EUR; hedge funds = HFRX Global Hedge Fund USD; real estate = SEB PB Real Estate EUR; private equity = LPX50 EUR; commodities = DJ UBS Commodities TR EUR.

Source: SEB

MODERN INVESTMENT PROGRAMMES AT THREE RISK LEVELS – ALLOCATION OF ASSETS

MODERN PROTECTION

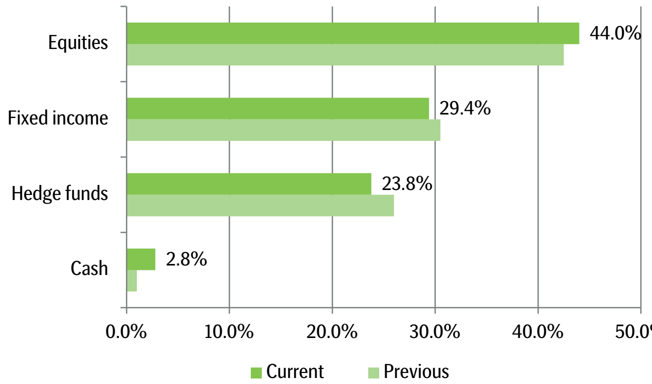
During the past three months, we made changes in both the fixed income and hedge fund sub-portfolios. The portfolio had a tactical cash reserve during the summer, but this has now been invested. In the absolute return segment of fixed income, consisting of managers with flexible mandates, we sold off some funds and bought new ones. The aim has been to build a stable sub-portfolio that we expect to deliver positive returns while the downside should be limited. In October we also made some adjustments in the hedge fund sub-portfolio. There we reduced our exposure to the credit long/short asset category and instead invested in new market neutral equity hedge funds focusing on Europe and the US. We believe that these holdings together diversify the portfolio.



Source: SEB

MODERN GROWTH

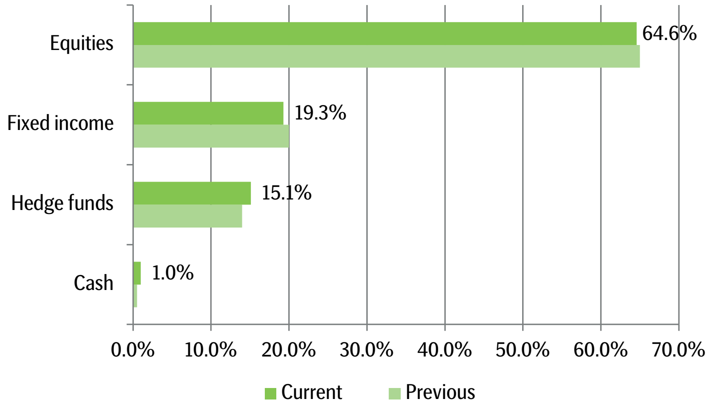
The portfolio entered the past three months with a relatively high proportion of equities. This weighting remains, but during the quarter we made some changes in the equity fund sub-portfolio. This included some reduction in our overweighting of Europe, while reducing underweighting of the US. We also took profits on the portfolio's exposure to Chinese equities. In the hedge fund sub-portfolio, we reduced exposure to the credit long/short asset category and instead invested in market neutral equity hedge funds focusing on Europe and the US, which we believe together diversify the portfolio further. We are sticking to our assessment that the world economy, led by the US, will continue to recover. Meanwhile, we expect the world's central banks to remain supportive of financial markets in general and riskier asset classes in particular.



Source: SEB

MODERN AGGRESSIVE

We increased the portfolio's equities weighting during the summer and began the quarter with 65 per cent equities. This weighting remains today, with some changes. This included some reduction in our overweighting of Europe, while reducing underweighting of the US, but exposure to European equities remains a clear theme in the portfolio. We also took profits in the portfolio's China fund and sold off our exposure to frontier markets completely. We restructured the hedge fund sub-portfolio by reducing the weighting of credit-related hedge funds in favour of market neutral equity hedge funds focusing on Europe and the US, which we believe together diversify the portfolio in a better way. In light of our positive view of financial markets going forward, based on both global economy conditions and the world's central banks, we are maintaining a relatively high proportion of equities.



Source: SEB

Alternative paths for world economy

Our main scenario is that the current rather slow economic upturn may continue for quite a while. But there are alternative scenarios, such as a repeat of the Japanese crisis, secular stagnation and a surprisingly positive scenario.

The economic upturn now under way began in the summer/autumn of 2009 and ever since then has been unusually slow in many countries. For instance, in the United States, this recovery has been the weakest so far of the entire post-war period. Meanwhile, financial assets have climbed significantly in value. Since the spring of 2009, investments in global equities have generated an average annual return of 20 per cent, while the corresponding figures for corporate bonds and government bonds have been 11 and 6 per cent, respectively. Economic and financial market trends in recent years have certainly been unusual, which naturally raises the question of how things will unfold in the years ahead.

The last issue of *Investment Outlook* (September 2014) included a theme article which maintained that the current economic and stock market upturn has the potential to continue for several more years. Our analysis showed that upswings after recessions/bear markets that had resulted from burst speculative bubbles were usually lengthy. Clearly, the financial crisis of 2008/2009 was due to a bursting of the sub-prime housing bubble in the US. While historically such upturns have been lengthy, they have also been slow and sometimes characterised by heightened uncertainty.

Our main scenario is still that the economic upturn now under way will continue for quite a while and at a moderate pace. But this, of course, does not rule out the global economy instead taking an alternative path. The aim of this theme article is to examine three such alternatives and see how different types of financial assets might perform.

1) Repeat of the Japanese crisis

A more unfavourable scenario for the next few years would be if Europe, the US and Japan were to pursue an economic path like the one taken by Japan in the 1990s/early 2000s. Among the factors underlying the Japanese crisis were speculative bubbles in real estate and equities during the 1980s, which were punctured in 1989-1990 by the Bank of Japan (BoJ)'s sharp tightening of monetary policy. This tightening was the catalyst for the combination of stagnation, recurring recessions and deflation (general decline in prices) that was predominant in Japan for more than a decade. In the period 1992-2003, Japanese GDP per capita grew at an annualised average rate of just over 0.5 per cent, while consumer prices were generally stable.

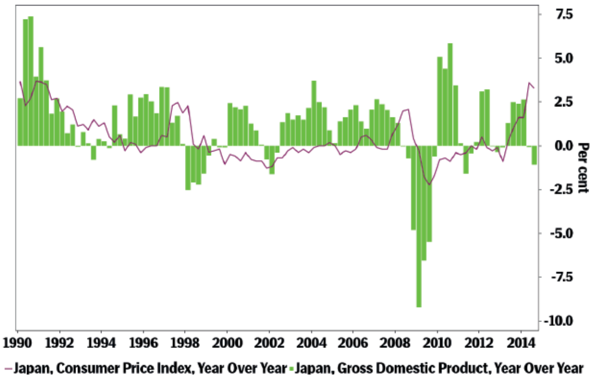
The unusually long duration of the Japanese crisis was due to a series of failed economic policies. Despite the deep recession of 1992-1994, the BoJ cut its key interest rate at a leisurely pace, and the money supply continued to shrink for many years. Although Japanese political leaders implemented stimulative budgetary measures in the early 1990s, these were modest and focused on increased public expenditures, which had only temporary positive effects on the economy. Another serious policy error was not to address the emerging bank crisis at an early stage. Instead, efforts to reform the country's financial system were not launched until the crisis had been under way for 7-8 years.

Last but not least, it should be noted that Japanese political leaders were completely unprepared for the deflation that hit the country, and were unable to prevent it from taking hold. One important lesson is that it is better to "overshoot" in economic policy than attempt too little. Excessive stimulus can be corrected later. That is a small price to pay for avoiding deflation, an economic condition that has proved to be particularly difficult to escape.

The situation today in the industrialised OECD countries shows far more differences than similarities with Japan in the early 1990s. This is especially true of economic policy actions, which since the economic and financial crisis have been dominated by forceful stimulus measures mostly of a monetary nature, aimed at bolstering the economy and ensuring that deflation does not take hold. Problems first with US and then European banks were handled with decisiveness, and these actions have clearly met with success.

However, what institutions such as the International Monetary Fund would like to see is greater fiscal stimulus, especially in Europe. In Japan, there has been a delay in launching concrete, forceful structural measures to boost the country's potential growth – the "third arrow" in Prime Minister Shinzo Abe's economic strategy, known as "Abenomics".

THE JAPANESE ECONOMY'S LONG TREK THROUGH THE WILDERNESS



Source: Macrobond

The 1990s and the first decade of the 21st century in Japan were dominated by a number of recessions and periods of deflation. The reasons for this were the Bank of Japan's interest rate hikes in 1989-1990 aimed at bursting speculative bubbles in real estate and equities, as well as a series of failed economic policy measures. For the past two years, the country has pursued Prime Minister Shinzo Abe's economic strategy, known as "Abenomics". This has promoted growth and caused prices to rise in the short term. However, it is uncertain whether this strategy will meet with economic success in the long term.

2) Secular stagnation

A second scenario is "secular stagnation", which in some respects is reminiscent of the Japanese crisis, but is less serious. The concept was introduced in 1938 by the US economist Alvin Hansen, who was influenced by the economic hard times following the Depression of the early 1930s. The secular stagnation concept was later reintroduced by Lawrence H. Summers, an economics professor and US Secretary of the Treasury in 1999-2001.

Secular stagnation can be defined as a condition in which average economic growth over a decade or more is far slower than the long-term trend, while inflation and interest rates are also low. Its characteristics include weak demand for goods and services along with a high level of savings, resulting in unemployment and large unutilised production capacity.

People associated with this school of economic thinking believe that US economic upturns since the 1990s have been slow for reasons other than those we noted in the September issue of *Investment Outlook* (that earlier recessions had been triggered by burst speculative bubbles). A number of arguments have been advanced and discussed as to why the US economy is now in secular stagnation, with insufficient demand.

The demographic trend is unfavourable. Population growth is slowing, which means the demand for goods and services will be lower than if the population increased more rapidly. The percentage of Americans retiring over the next 10-15 years is also growing rapidly, and they prioritise saving for retirement over high consumption. Furthermore, economic inequality among US households is on the rise, and since the growing category of high income earners spends less of every new dollar of income than low income earners, this affects overall consumer demand.

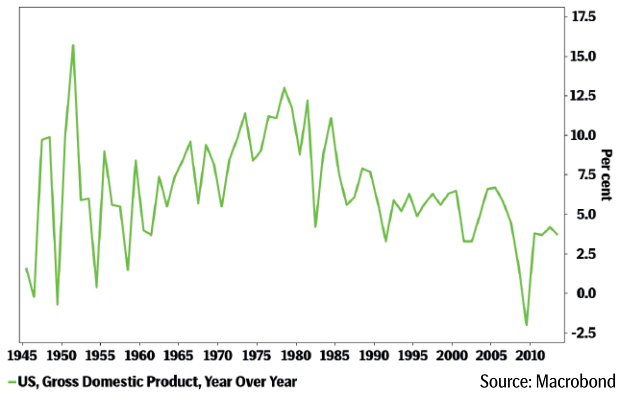
Meanwhile, the structure of the US economy is changing. The percentage of service sector companies with no need for traditional capital investment is growing, whereas the percentage of "old" industrial companies is falling. As a result, capital spending on property, plant and equipment is declining, which is why demand for such investment is becoming less significant.

At the same time, investment costs have plunged, which means that each investment requires less funding than previously, reducing capital spending and thus total demand in the economy. Another factor that has a negative effect on traditional investment is the trend towards lower growth since the late 1990s. This means that companies today have less incentive to invest, since they expect slow growth and thus weak demand going forward.

Moreover, in the US the period of consumption fuelled by ever-greater borrowing that began in the early 1980s was followed by a period of gradual reduction in household debt. That affects growth in private consumption, which accounts for about 70 per cent of the country's GDP.

Finally, a number of economists, including former Federal Reserve (Fed) Chairman Ben Bernanke, have highlighted the substantial excess global savings that are a result of Asian central banks accumulating large-scale foreign exchange reserves after the 1997 financial crisis in Asia.

THE SLOWEST US ECONOMIC UPTURN IN MODERN TIMES



Source: Macrobond

US economic upturns following recessions over the past few decades have been unusually slow. The recovery that began in the summer of 2009 is the weakest in modern times (the chart shows GDP growth). One explanation for this pattern could be that the last few recessions were triggered by burst speculative bubbles, which usually pave the way for slow subsequent upturns. Another explanation might instead be that the US has been in secular economic stagnation for about the past 25 years.

The ongoing debate among scholars about whether there is secular stagnation has focused mainly on the US. However, it is worth noting that the US economy in relative terms has performed far better over the past ten years than the euro zone and Japan. While annual average growth in the US during that period was 1.6 per cent, it was 0.7 per cent in both the euro zone and Japan. Average US inflation during the same period was 1.7 per cent, compared to 1.5 per cent in the euro zone and -0.4 per cent in Japan. The arguments for secular stagnation in the US are even more applicable to the euro zone and Japan. For instance, in demographic and growth trend terms, the economic situation and outlook are far more unfavourable in the euro zone than in the US.

There is no lack of economic policy prescriptions for treating secular stagnation. Since insufficient demand is a key problem, the suggested cure is fiscal stimulus, especially when it is so cheap for governments to borrow as it is today. There are also calls for accommodative monetary policy, focused on raising inflation expectations and in some cases triggering falling exchange rates. Another prescription is measures aimed at the supply side of the economy (production) in order to increase potential growth, for instance, by means of a higher retirement age, education and training to raise the quality of labour and tax reforms to encourage capital spending.

3) A surprisingly positive scenario

The global economy may of course also exceed our expectations in the years ahead, in terms of growth and improved economic strength and balance.

Driving forces in such a scenario might be economic structural reforms in the euro zone, Japan and India; a rapid and smooth transition from investment-led to consumption-led growth in China; the absence of dramatic commodity price hikes; and the establishment of lower oil prices mainly as a result of the energy revolution in the US, which is becoming increasingly self-sufficient. Other potential drivers are progress in efforts to deregulate and expand global trade and an easing of geopolitical tensions.

One important piece in this positive scenario puzzle would be several years of sustained healthy economic growth in the US, which would also have beneficial effects on the rest of the world economy. Today the US economy shows many strengths. Household balance sheets have become stronger thanks to debt deleveraging and growing wealth. An increasingly strong labour market will probably lead to gradually higher wages and salaries. Housing construction and business investment should be able to recover within a few years, after a weak period. The federal government's finances have improved remarkably over the past several years. There is little risk of either deflation or high inflation. And by all indications, the Fed will not tighten its monetary policy at a pace that would jeopardise a sustained economic upturn.

Consequences for financial assets

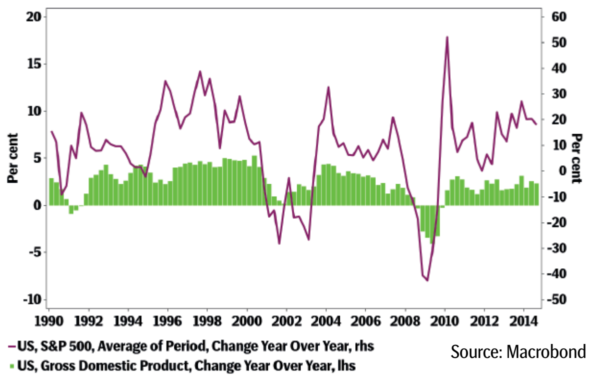
Assessments of how different financial assets will perform in our main scenario are presented in the "Portfolio strategy" section on pages 6-9. But how would they perform in these alternative scenarios?

By all indications, a repeat of the 1990s Japanese crisis would be devastating for equities. During that crisis, the Tokyo Stock Market fell sharply – by an annual average of about 4 per cent. Lessons can also be learnt from the US of the 1920s and 1930s. The combination of deflation and recession/depression in the early 1930s caused share prices to plunge, while inflation benefited fixed income investments. On the other hand, when deflation was instead combined with economic growth during some periods of the 1920s and late 1930s, equities performed well.

A secular stagnation scenario would in itself be beneficial for fixed income investments, but given today's historically low bond yields, there would be very little room for a fall in yields/rise in prices. Slow growth, small price increases and low interest rates would together pave the way for low returns on equity investments. Sectors that initially have low valuations, and companies with high dividend yields and/or stable growth, should do better than the stock market in general.

In a surprisingly positive global economic scenario, there is a clear upside for equities, since the risk premium for equities (corporate earnings/share price minus government bond yield) is now high. This reflects low growth expectations and great uncertainty about economic prospects. If these expectations are exceeded and uncertainty diminishes, cyclical equities and companies with high expected earnings would benefit at the cost of defensive equities and companies with stable growth. Financial service shares may also be among the winners in that case. The risk premium on government bonds is currently quite low, which as such clearly signals a risk of rising interest rates in an unexpectedly good scenario.

STOCK MARKET RALLY DESPITE UNUSUALLY SLOW GROWTH



Source: Macrobond

The positive correlation between stock market performance and economic growth is well documented, for example in the US. This correlation has also held during the most recent economic upturn, which began in the summer of 2009. The rise in share prices has been significant, considering that in historical terms growth has been slow for an expanding economy (the S&P 500 index is up about 225 per cent since March 2009 calculated in USD). Reasons for this include the Federal Reserve's aggressive stimulus policy, record-low bond yields and the fact that wages make up a shrinking share of total income in the US, while corporate earnings have increased as a percentage during this period.

Bank stress tests take Europe in right direction

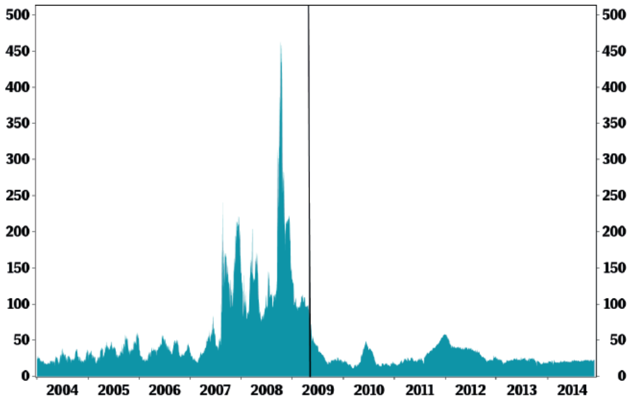
Today's economy cannot function without efficient, reliable payment and credit systems. European regulators recently unveiled the results of their 2014 stress tests of banks in the European Union and Norway, aimed at showing how these banks would fare under adverse market conditions and assessing systemic risk in the financial service sector. The outcome seems to have been fairly well received by the market and can be viewed as an important step in the right direction.

When the financial crisis was raging at its worst in 2008-2009, the US government and the Federal Reserve initiated a long series of aggressive steps to stabilise the financial system. The collapse of Lehman Brothers – combined with huge problems in a number of other major financial institutions such as the country's biggest mortgage lenders Fannie Mae and Freddie Mac and the insurance company AIG – required gigantic bail-outs and liquidity injections. Altogether, the authorities provided liquidity injections, recapitalisations and guarantees which peaked at nearly USD 7 trillion, in order to stabilise a financial system totalling about USD 30 trillion. Public sector rescue efforts consisted of a mixture of direct capital injections in the institutions that were nationalised, recapitalisations of private banks, deposit guarantees for both traditional bank accounts and debt securities and unconventional credit facilities at the Federal Reserve, which pumped an enormous amount of cash into the market.

Despite these record-sized bail-outs by the US federal government and its central bank, investors and savers became extremely nervous. Banks also distrusted each other to a nearly unprecedented extent. Until then, rescue packages had only addressed capital and liquidity problems, but confidence was still badly damaged. Without confidence, the financial system cannot function.

The 2009 US stress tests

In order to restore confidence in commercial banks – a vital element of the financial system – in February 2009 then-Treasury Secretary Timothy Geithner unveiled a plan outlining how US authorities intended to review the balance sheets of banks and simulate tests of how these banks would fare in the event of an economic downturn of historical dimensions ("stress tests"). Banks deemed incapable of weathering an economic collapse – including a dramatic decline in real estate prices and higher unemployment – would immediately have to raise fresh risk capital from investors or else would be forced to accept government capital injections on unfavourable terms.



Source: Bloomberg

US BANKS REGAINED CONFIDENCE IN EACH OTHER AFTER THE MAY 2009 STRESS TESTS

The chart shows the risk premium on US interbank loans compared to the yield on 3-month Treasury bills. Despite record-sized capital and liquidity injections into the financial system, US banks remained reluctant to lend to other banks without high risk compensation well into 2009. The risk premium fell dramatically after publication of the US stress tests in May 2009.

Criticism of this stress test plan was widespread and immediate. The stock market plunged as soon as the plan was unveiled. The market mistrusted both the scope and methodology of the plan, as well as the impact that could be expected. Many feared that the stress tests would not be especially tough and that the results could thus not be viewed as an indication of what might happen in an actual pessimistic economic scenario. Others suspected that federal authorities would issue a flattering report on the strength of the banks – aimed at instilling confidence in banks that did not actually deserve such confidence at all – in order to prevent capital flight and new emergency measures.

Among those who still believed in the authorities' methods and good intentions, some feared what the tests would reveal. Others maintained that some banks would obviously prove incapable of coping on their own with a further deepening of the economic crisis and argued that the authorities should act in advance of the test results by nationalising various large institutions. There was also widespread public distrust of all official emergency measures. These were regarded as rescuing mismanaged institutions, their executives and imprudent financiers. The political right described such measures as socialism.

When the report was finally published in May 2009, the direct response was mixed, yet most people seem to have perceived the results as credible. Important indicators of mistrust and stress in the financial system eased significantly over the following weeks. The risk premium on interbank loans plummeted, as did the cost of insuring an equities portfolio against further share price declines. In retrospect, it appears that the US stress tests marked a clear turning point for the better. The outcome was positive, even though – or perhaps because – the report cannot be described at all as a pure "acquittal" of the banks. Ten banks were forced to raise an additional USD 75 billion in risk capital, but nearly all of them did so without public aid within one month.

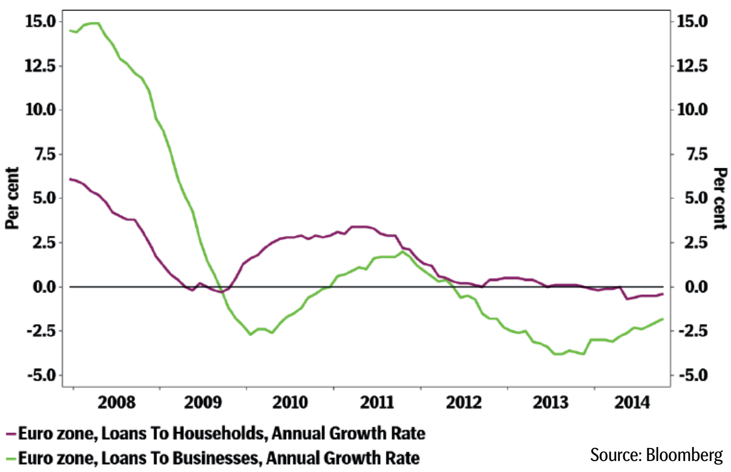
Twenty months later, the scale of official bail-out measures had been reduced from nearly USD 7 trillion to less than USD 1 trillion. When the results of the US government's capital injections during the 2008-2009 crisis were summarised in 2013, the government turned out to have made a profit of USD 166 billion on them. But above all, the financial system had begun a gradual recovery and had helped sustain the US economic recovery for several years. In Europe the situation is quite different, and this American success story is probably a cause of great envy among European politicians and central bankers.

The bloodstream of the economy

In order for the economy to grow, credit expansion is not necessary (although it helps), but a functioning credit system is vital – a system for allocating capital from those with a savings surplus to those who need funding. This may include allocating capital from mature companies and older but not yet retired households to expanding businesses and younger households. When there is no access to capital even for sound investments – based on well-documented financial projections – this greatly impedes economic activity.

There are probably many reasons why businesses and households in the euro zone are paying down their debts on a net basis, but it is critical to future economic growth that this should not be due to lack of access to funding. In particular, small and medium-sized businesses as well as households are dependent on the availability of traditional bank loans. In some parts of Europe, debts are now being amortised at a pace that is devastating to aggregate economic demand.

To ensure the availability of credit in Europe to financially sound borrowers, solvent and well-funded banks are necessary. In order to function properly, these institutions also need solid confidence from the general public and investors. The latest



Source: Bloomberg

EURO ZONE CREDIT GROWTH IS NEGATIVE

The chart shows the net growth of lending by financial institutions to businesses and households in the euro zone. Does this negative growth reflect a dysfunctional credit system, or only weak demand?

round of stress tests, which included ensuring the underlying quality of the assets in banks' balance sheets, was an important step towards a stronger banking system in Europe.

Concurrently with the stress tests, the European Central Bank (ECB) also launched long-term credit facilities and bond purchases in order to revive the market for packaged loans, thereby allowing credit expansion outside the banks' own balance sheets. As the US example showed, however, supportive actions by a central bank are not enough if there is a shortage of confidence and capital in commercial banks.

Scary precedent in Europe

European public authorities and banks are nevertheless facing a difficult uphill battle. European stress tests suffer from the same public scepticism and criticism as did the US tests in 2009, but in addition they have their own history to contend with. As recently as 2011, the European Banking Authority (EBA) tried unsuccessfully to repeat the American stress tests. Not only did its report fail to revive confidence in the banks, but it also soon turned out that scepticism about the EBA's stress test results was justified. Only three months after the report had awarded high marks to Belgian-based Dexia, that bank was forced to undergo a government-funded restructuring. Another institution that passed the 2011 tests was Portugal's Banco Espirito Santo, which collapsed earlier this year after large loans with insufficient collateral provided to companies closely tied to the bank's main shareholder had been revealed.

The 2014 stress tests in Europe

On October 26 the results of the 2014 stress tests of banks in the EU and Norway were published.

The purpose of the tests, in the words of the above-mentioned EBA, was: "... to assess the resilience banks in the EU to adverse economic developments, so as to understand remaining vulnerabilities, complete the repair of the EU banking sector and increase confidence."

Put another way, the purpose of the tests was to demonstrate how the banks would cope with adverse market conditions such as a recession and to evaluate systemic risk in the financial sector, meanwhile giving regulators such as Sweden's Financial Supervisory Authority a better factual basis for evaluating individual banks.

Another objective that was cited when carrying out the stress tests on European banks is confidence-building after what happened during the financial crisis, when various governments were forced to launch large-scale rescue actions.

Perhaps in light of the less-than-successful 2011 tests, a lot of effort has gone into ensuring reliable methods, based on how the banks in question can cope with various macroeconomic scenarios. The stress tests focused on a set of risks including both credit and market risks, such as sovereign exposures and funding risks. Trading and off-balance sheet exposures were also part of the tests.

Different forms of stress tests are commonly employed in the banking industry, and individual banks often use them in their operations. In addition, such tests are conducted by local regulators, although their methods and purposes may vary. It was therefore essential to apply a common set of assumptions and methodology.

Swedish banks are well equipped

A total of 123 banking groups from 22 countries were tested by the EBA. At the end of 2013, their assets amounted to EUR 28 trillion and represented about 70 per cent of total banking assets in the EU.

A total of 24 out of 123 banks failed the stress tests. In all, these banks had capital shortages of about EUR 24 billion. Concurrently with these results, the ECB published a similar survey of 130 banks, of which 25 were classified as needing to raise fresh capital. Of these 25 banks, 12 had already taken action by raising new capital to cover their shortfalls. The ECB came out with a higher total than the EBA (25 vs. 24) because Spanish-based Lisserbank passed the stress tests but not the ECB's asset quality review.

It was expected that some banks would have problems and fail the tests. Worth noting is that all major German and French banks passed the tests. This was a bit surprising, since some observers have expressed concerns about German banks. Deutsche Bank passed the stress tests by a relatively wide margin, while Commerzbank was significantly closer to the EBA's threshold values. Likewise, British-based Lloyds Banking Group barely passed the tests and is now being subjected to further examination by the Bank of England.

In Sweden, the tests covered Handelsbanken, Nordea, SEB and Swedbank. All of them passed by relatively wide margins.

After the stress tests had been carried out, the Swedish Financial Supervisory Authority (FSA) wrote that these banks "at present have sufficient capitalisation and resilience given a scenario of sharp deterioration in business conditions".

According to the FSA, Swedish banks are well equipped to cope with disruptions in their surroundings, partly because Sweden has introduced higher capital requirements than many other countries.

The market reacted calmly to the tests

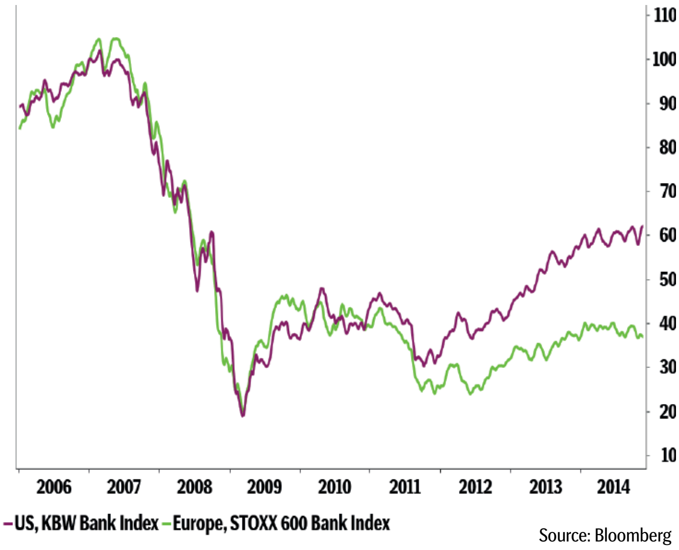
But the question is what these tests really mean and how much we can rely on them.

One example in this context is the above-mentioned Portuguese problem bank Espirito Santo. The bank passed the 2011 stress tests, but earlier this year it was forced into a government bail-out. The 2014 round excluded Novo Banco (created as part of the Espirito Santo bail-out) from the stress tests, which were postponed in its case.

Judging from the comments of market players, the 2014 tests do not appear to have encountered the same scepticism, but although their overall outcome was reasonably consistent with expectations, there were widespread sell-offs of European banking shares when the markets opened for trading after the test results were published. There were major differences between the various banks, however.

Summary – a step in the right direction

Unfortunately, we doubt that the 2014 European stress tests will ever be regarded as the important turning point for confidence in European banks in the same way as the 2009 US tests were. However, they are a step in the right direction. Stronger confidence in European banks is also critical to ensure better economic growth in the region. If the stress tests, combined with ECB stimulus measures, were also supplemented by structural reforms in weak European economies, the potential for a healthy recovery would be better than for a long time.



Source: Bloomberg

SINCE THE CRISIS, US BANK SHARES HAVE OUTCLASSED EUROPEAN ONES

The chart shows the indexed share price trend for US and European banks since 2007. The price collapse of 2007-2008 was almost identical on both sides of the Atlantic, as was the rebound immediately afterward. But since the 2011 euro zone crisis, they have diverged dramatically. The mutual dependence between healthy banks and economic growth makes it difficult to determine to what extent the European lag is due to a weaker economy (which might itself be partly due to a dysfunctional credit system) and to what extent it reflects weaker fundamentals, a lack of bank restructuring and lower confidence in banks.

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Markets and asset classes

Macro summary

Cheaper oil gives world economy more energy

- *The global economic upturn remains fragile*
- *The battle against deflation enjoys top priority in monetary policy*
- *Thanks to falling energy prices, the probability of unexpectedly high growth has increased*

Worries about world growth and accompanying share price declines this summer and early autumn have been followed by signs of economic stabilisation, coupled with stock market rallies and falling bond yields. The latter shows that continued commodity price declines have lowered inflation expectations and increased the probability of further monetary policy stimulus and postponement of fiscal austerity measures. The global economic upturn is still fragile, but the determination of economic policymakers should meanwhile not be underestimated. This is especially true of monetary policymakers, who have made the battle against deflation (a general decline in prices) their highest priority. There are also hints of greater acceptance for more expansionary fiscal policies. Overall, the world economy appears capable of growing faster in 2015 and 2016 than this year. Thanks to falling energy prices, the probability of unexpectedly high growth has increased, while heightened tensions between Russia and other countries continue to pose a risk to growth.

The US economy is doing well...

After the weather-related decline in gross domestic product (GDP) during the first quarter of 2014, US growth accelerated significantly. Both a strong labour market and better household sentiment indicate that private consumption is about to strengthen greatly. We expect GDP to grow by 2.2 per cent this year, 3.4 per cent next year and 3.1 per cent in 2016. Looking ahead, good growth will be coupled with far lower inflation due to a stronger US dollar and cheaper oil. This will persuade the Federal Reserve to hold off on its first key interest rate hike until September 2015. Since 2010, the federal government has been highly successful in reducing its budget deficit, which has shrunk from more than 10 per cent to less than 3 per cent of GDP in only four years.

... while the euro zone is doing worse

Euro zone GDP grew by only 0.2 per cent in the third quarter, with many countries facing low demand and struggling with structural problems. Germany's economy has lost momentum, while Spain's has been surprisingly strong. Because of near-stagnation in the euro zone economy and the risk of deflation, the European Central Bank has expanded its stimulus programmes. There have been cautious steps towards easing fiscal policies. The new president of the European Commission, Jean-Claude Juncker, has unveiled a plan to boost infrastructure investments. The weakening euro will also help exporters, and falling oil prices will boost household purchasing power while lowering company costs. But we predict that euro zone GDP will increase by a mere 0.9 per cent both this year and next, accelerating to 1.3 per cent in 2016.

British growth tops major industrialised countries

While some economic indicators were weak early in the autumn, there are many signs that British growth will be solid in 2014-2016. The prospect of inflation below the Bank of England's 2 per cent target for several years to come will strengthen household purchasing power and persuade the BoE to wait longer than previously expected to hike its key interest rate. Meanwhile the labour market will gradually improve, enabling private consumption to increase faster. We predict GDP growth of 3.1 per cent this year – the highest among the G7 major industrialised countries – followed by 2.8 per cent in 2015 and 2.5 per cent in 2016.

Nordic economies are following different paths

The Swedish economy is showing continued two-speed performance – with healthy domestic demand and weak exports – but we expect overall growth to be good in 2015-2016. The Finnish economy is facing headwinds in the form of structural problems in the business sector, significant setbacks for exports to Russia and belt-tightening in the public sector. We expect Finland's GDP to fall for the third straight year in 2014 and then climb slowly. Denmark's GDP has increased unexpectedly little this year, but the outlook appears favourable. Norwegian growth will slow markedly in 2015 due to falling oil investments but is expected to accelerate in 2016. We believe that GDP in the Nordic countries overall will grow by 1.5 per cent this year, 1.8 per cent in 2015 and 2.1 per cent in 2016.

Japan back in recession

When "Abenomics" was launched in the winter of 2012/2013, with a focus on monetary and fiscal stimulus measures, the Japanese economy grew rapidly. Since then it has gradually lost momentum, and this year it fell back into recession. Right after the consumption tax hike in April 2014, the economy fell sharply. GDP also shrank in the third quarter. We predict that GDP will increase by 0.4 per cent this year, 0.9 per cent in 2015 and 1.1 per cent in 2016. Among bright spots are growing employment and weakly rising pay, which will benefit household incomes. But wages and salaries are not increasing enough to speed up inflation, which is now tending to fall. Looking ahead, it will thus be hard to make the 2 per cent inflation target credible, indicating a need for further monetary stimulus.

Accelerating growth in emerging Asia

There is good potential for faster growth in most Asian emerging market (EM) countries. Strong labour markets are helping to drive domestic demand. Increased world market demand will also provide a helping hand. Economies in an especially good position are South Korea, Singapore and Taiwan, while countries with large current account deficits such as Indonesia are vulnerable. Low inflation in the region will allow continued supportive monetary policies.

In China, increased exports are partly offsetting sluggish domestic demand. Slower growth will give Chinese authorities a reason to continue with targeted measures and persuade the central bank to lower its lending rate further. We expect GDP to expand by 7.4 per cent this year, 7.0 per cent next year and 6.7 per cent in 2016. India will benefit greatly from cheaper oil, which will lower inflation and give the central bank a reason to cut its key interest rate in 2015. The government of Narendra Modi has not yet really met expectations of speedy reform efforts, but conditions are now in place for more far-reaching reforms that will attack structural problems (market regulation) and benefit growth. We predict that India's GDP will increase by 5.3 per cent this year, reaching 5.8 per cent in 2015 and 6.2 per cent in 2016.

Latin American curves point the wrong way

This year, most macroeconomic curves have been pointing in the wrong direction in Latin America. Growth has slowed, inflation has increased and deficits in both the current account and public finances have become larger. The Brazilian economy is stagnating and the outlook is not especially promising, especially since there is little confidence in the ability of newly re-elected President Dilma Rousseff to get the economy back on track. In Argentina there is very high inflation, which will probably be even higher in 2015. Financial ratios are far more favourable in Mexico and Chile. We expect overall Latin American GDP to grow by 1 per cent this year, 2 per cent in 2015 and 3 per cent in 2016.

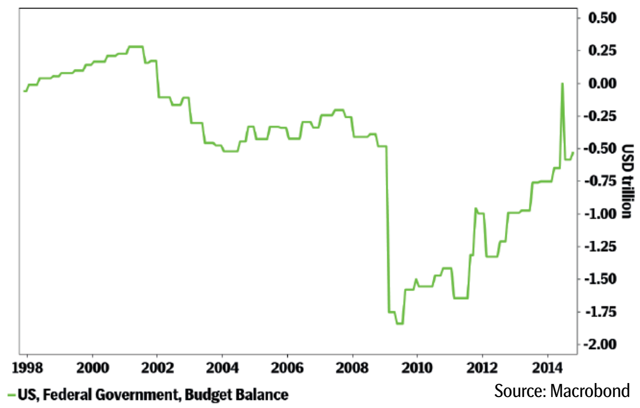
Mixed economic outlook for Eastern Europe

We expect the Russia-Ukraine conflict to be lengthy, leading to recession in Russia during 2015 and economic stagnation in Ukraine. Yet gradual recovery will continue in much of Central and South-Eastern Europe, due to the continued expansion of private consumption, increased exports to the West and cheaper oil, which will benefit many of the countries that are large energy importers. Economic policies, on the other hand, will not do much to stimulate growth. Countries whose economies are especially hurt by large trade exposure to Russia are former Soviet republics in Central Asia, Finland and the Baltic countries.

During 2014, the Baltic economies were pulled down by Russia's decelerating growth and its import ban, as well as by the euro zone slump. Capital spending in the Baltics has been persistently weak, while construction and especially household consumption have been positive forces. The Russia-Ukraine conflict will hamper Baltic exports in 2015 as well. Private consumption will thus continue to be the main growth engine. Consumption will benefit especially because wages and salaries adjusted for (low) inflation will climb by a rapid 4-5 per cent annually. The prospects of somewhat higher exports to Western Europe and a weaker euro will also be positive growth factors.

Higher global growth in our forecast

Looking ahead, world economic growth will accelerate according to SEB's forecast. After this year's 3.5 per cent GDP increase, global growth will be 3.8 per cent in 2015 and 3.9 per cent in 2016. EM countries will continue to grow the fastest, almost 5 per cent yearly in 2015-2016, but the gap between EM and developed market (DM) countries will shrink next year as DM growth accelerates to 2.4 per cent, following this year's 1.9 per cent. In 2016, the EM sphere will continue to grow about twice as fast (4.9 per cent) as DM countries (2.4 per cent).



Source: Macrobond

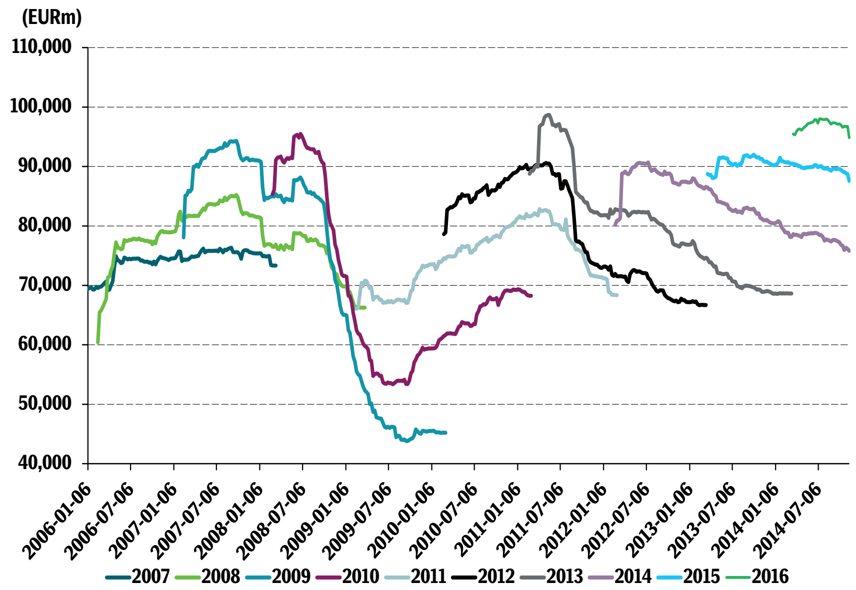
UNUSUALLY RAPID US BUDGET IMPROVEMENT

When the US federal budget became larger than 10 per cent of GDP during the economic and financial crisis 5-6 years ago, "everyone" working in financial markets and economic research organisations was worried. Since then, the deficit has shrunk surprisingly fast and is now below 3 per cent of GDP. In dollar terms it is close to pre-crisis deficit levels. Fiscal tightening, lower funding costs because of lower interest rates/yields and economic growth are reasons behind this change of fortunes.

Roller coaster with a positive trend

- **Dare to defy the mood of the day**
  Imbalances and an unstable upturn are creating continued volatility, which implies both risks and opportunities.
- **Low interest rates and bond yields are driving capital into the stock market**
  Investors who need returns are now being forced to take more risk, which means that a significant portion of their capital will go into equities, where stable companies appear to be best positioned.
- **Earnings are growing, but more slowly than expected**
  Weaker economic momentum than previously expected is holding back earnings in cyclical companies.

EARNINGS ARE GROWING, BUT LESS THAN PREVIOUSLY ESTIMATED



Source: SEB

The chart shows adjusted net income expectations for listed Nordic companies in millions of euros for each year over the past nine years. Earnings forecasts have been trending downward for three years. The levelling-out that was discernible after this year's six-month reports turns out to have been only a temporary plateau. Earnings are still expected to grow during the coming years but will be less than previously anticipated.

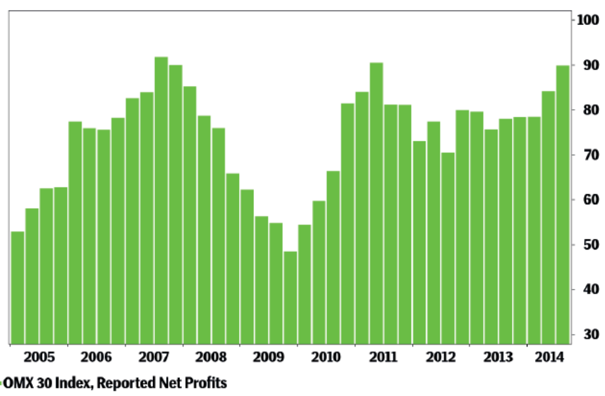
Between September 2011 and June 2014, the Nasdaq OMX Stockholm and Nordic equity indices gained about 70 percent (including dividends), after which we have seen a flat consolidation. The upturn was driven entirely by falling return requirements, but earnings declined slightly. Weak earnings growth, both absolute and relative to expectations, is holding back the market while extremely low interest rates and bond yields along with ultra-loose monetary policies are providing support on the positive side. We have repeatedly been hopeful of better earnings growth, most recently three months ago after companies published encouraging six-month reports, but the trend towards downward revisions in analysts' earnings forecasts is unfortunately still intact. This weakness should not be overdramatised, however. Earnings are growing again, but earnings increases over the next few years look set to be smaller than previously anticipated. With today's non-existent interest rates and with dividend yields on the Nasdaq OMX Stockholm at nearly 4 percent, slightly rising share prices are enough to enable the exchange to provide an attractive total return

Dare to swim against the current

Given all the economic imbalances and political tensions in the world, the stage is also set for an occasionally volatile stock market journey. Nor are economic conditions, politics and virus epidemics the only things that are likely to contribute to volatile stock market performance. We also fear that the main reason for the attractiveness of equities – low interest rates and bond yields – has pulled in capital not usually invested in equities. This may have resulted in greater volatility and may even be suspected of intensifying downturns such as those in August and October.

A flat, but volatile, market means that investors should be able to achieve somewhat better performance than a benchmark index by going against the trend and buying during slumps, while reducing their holdings when the mood is cheerful. Unfortunately, by definition very few investors are able to buy when worries are greatest and sell when optimism is bubbling.

EARNINGS GROWTH IS BACK, THOUGH FRAGILE



Source Bloomberg

The chart shows the index of reported net earnings during the preceding 12 months for OMXS30 companies (the top 30 equities on the Stockholm exchange). Despite lower economic growth than expected, earnings have grown. Fashion retailer H&M, major banks and a weak krona are behind this year's earnings boost.

Worries about earnings, due to weak macro data

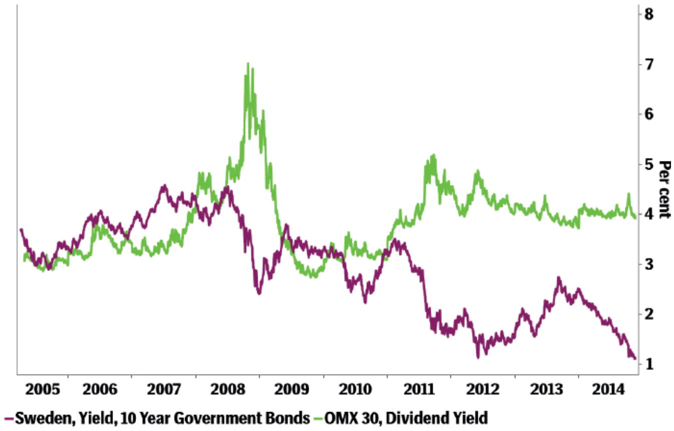
Macroeconomic statistics have provided downside surprises since March this year. During the summer, the flow of negative surprises in Europe became accentuated. Third quarter reports of nearly all major industrial companies detailed worsening business conditions during the summer. Several major industrial companies are thus also on the list of the year's worst-performing shares. Hopes of stronger earnings growth for listed companies – ignited by six-month reports indicating a trend reversal after several years of non-existent earnings – have been partly disappointed. SEB still expects earnings growth of about 10 per cent this year and about 15 per cent in 2015 for Nordic listed companies. Unfortunately, there is an obvious risk that these forecasts will prove too optimistic. These forecasts have been gradually adjusted downward for three years. The levelling-out that was noted after the six-month reports, especially in Sweden, was not a new trend; it was a temporary plateau. Above all, earnings forecasts for the more cyclical companies have been adjusted downward recently – for example industrial companies, but also oil companies and their subcontractors.

Stable alternatives are attractive

On the positive side, a weak economy means that central banks can be expected to keep stimulating the economy, and interest rates will be extremely low for a long period. Thus equities continue to be an attractive alternative for investors who want a return significantly above zero.

The dividend yield for OMXS30 companies is expected to be around 4 percent during the coming year, and today it is easy to put together a portfolio of companies that are relatively insensitive to economic cycles and that pay an even higher dividend yield. We know of 19 listed companies in Sweden with a market capitalisation exceeding SEK 5 billion that will provide a sustainable dividend yield above 4 per cent in 2014, 2015 and 2016. These 19 companies have an average market capitalisation of SEK 85 billion and are expected to pay a dividend yield of 4.9 percent for 2014 and 5.4 percent for 2015. They include banks, construction and real estate companies, retailers, gaming companies and telecom carriers, but also forest product and industrial companies. If we perform the same exercise in the Nordic countries, we can raise the bar to at least a 5 per cent dividend yield per year and we still end up with 35 companies in 14 economic sectors that meet this requirement.

Even if earnings growth proves to be somewhat worse than we are expecting today, for example due to a sluggish economic recovery, we expect capital to continue flowing into the stock market. In particular, shares in companies with limited cyclical sensitivity, stable balance sheets and high sustainable dividend yields will attract new investors – if not for any other reason, due to the lack of returns from other investments.



Source: Bloomberg/Macrobond

ATTRACTIVE RETURNS, EVEN WITHOUT LARGE SHARE PRICE UPTURNS

The chart shows expected dividend yields from OMXS30 equities during the coming year and yields on 10-year Swedish government bonds.

Greater risk-taking enlarges role of equities

- **Roller coaster in the world's stock markets**

  In September, cold autumn winds blew into the world's financial markets as geopolitical turmoil made itself felt in many places. Weak Chinese macro data made a bad stock market mood worse, with broad downturns as a result. In late October, share prices rebounded strongly and US equity indices reached new record highs.

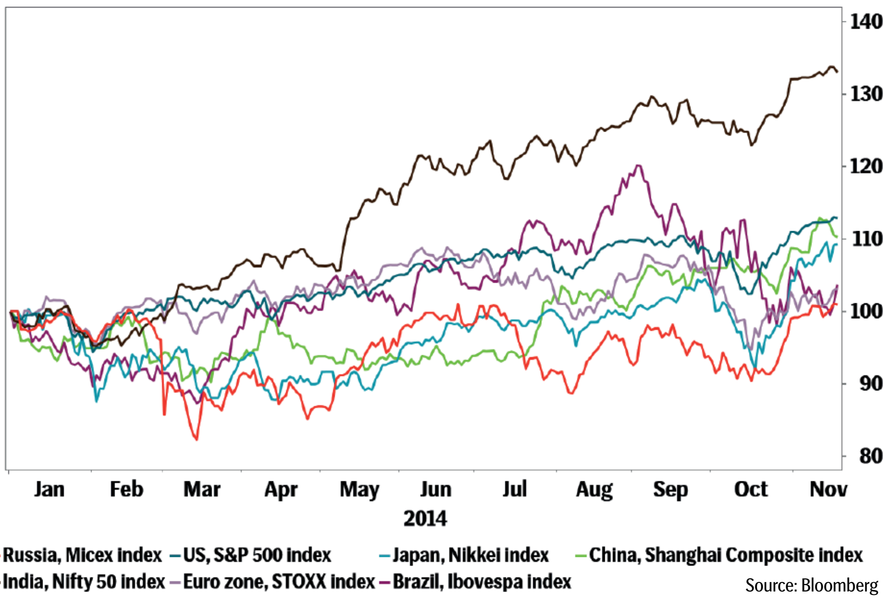
- **Positive driving forces in the US**

  American growth is gaining momentum and the US is first in the world economic cycle. This bright picture stands out in a global perspective, whereas macro data in other regions provide a mixed impression. US corporate reports for the third quarter showed better sales and higher margins than expected. Valuations are high, but strong earnings may justify these share prices.

- **Increased allocation to equities**

  Assuming strong growth in the US and central bank supportive measures, there is reason to expect equities to continue delivering good returns. A sustained upturn will also require support from corporate earnings, and we see positive signs there. We are increasing risk in our portfolios by increasing our allocation to equities.

2014 LOOKS SET TO BE ANOTHER GOOD STOCK MARKET YEAR



Source: Bloomberg

The MSCI All Country World Index has gained more than 8 per cent in local currencies this year. Stock exchanges in India and China (Shanghai) are at the top, while Brazil and Russia rank last. Brazil had a good start to the year but has lost all returns in the past three months. European macroeconomic data are creating some uncertainty, which is reflected in relatively weak stock market performance. In Japan, the equity index rebounded after an announcement that Japanese pension funds will increase their allocation to equities.

WORLD STOCK MARKETS HAVE PERFORMED STRONGLY in 2014, gaining more than 8 per cent in local currencies (as of November 25). India tops the stock market chart, but the Shanghai exchange and the broad S&P 500 index in the US are also performing well, with substantial gains. At the bottom are Russia and Brazil. European stock exchanges have also been disappointing.

An autumn mood and downturns dominated the markets in late September and early October, but this was succeeded by a strong recovery starting in mid-October, with new equity index records in the US as a result. US equities were supported by good corporate reports and strong macroeconomic data. In Japan, the stock market rose after the announcement that Japanese pension funds will increase their allocation to equities. Developed market (DM) equities have regained their lead, outperforming emerging market (EM) equities since early 2014. Pharmaceuticals and information technology shares are at the top, while commodity and energy shares have performed the worst.

Valuations are somewhat high, but earnings are growing

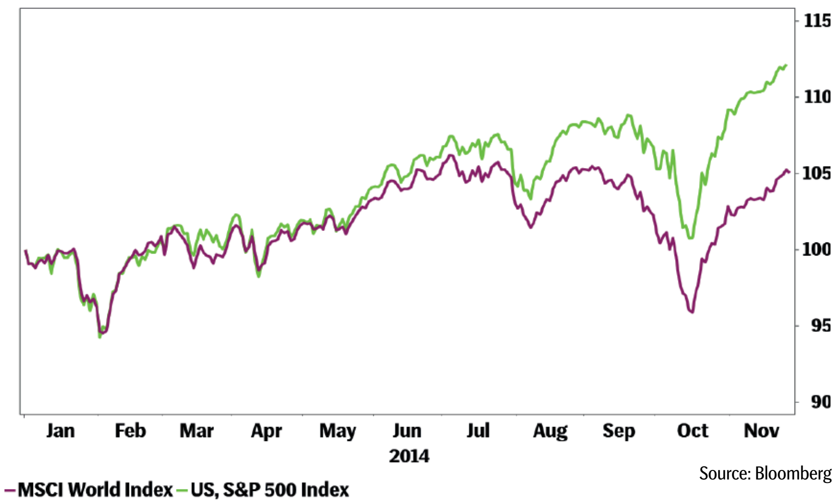
Overall company earnings are expected to grow by more than 5 per cent this year and by 11 per cent in 2015. Expectations have thus been gradually adjusted downward since spring, but corporate reports for the third quarter indicate that profits have bottomed out and are about to take off again. One positive sign is that 80 per cent of US companies exceeded earnings expectations and 60 per cent showed better sales than predicted. Global equities are valued at a price/earnings ratio of 15 for 2014 and a P/E ratio of 14 for next year's projected profits, which is at the higher end in a historical perspective. EM equities are cheaper than DM ones, but the gap has narrowed. China, South Korea, Russia and Greece have the lowest P/E ratios in the world. Russia and Greece are showing some of negative growth and are thus not especially attractive to invest in, while economic prospects look brighter in China and South Korea, where corporate earnings are expected to grow by an estimated 13 and 21 per cent, respectively, next year.

The US is first in the cycle

The American stock market has achieved record levels, driven by both positive macro and micro factors. Macro data in the United States is gradually improving, and the optimistic undertone in the economy stands out when compared to other regions of the world. During the second and third quarters of 2014, GDP rose by about 4 per cent, showing that growth is above the historical average. Purchasing managers' indices indicate month-on-month expansion, new jobs are being created, unemployment is falling and consumers are well equipped to spend a higher proportion of their disposable income.

During the reporting season in October and November, a number of top executives from major companies in various industries (for example General Electric, MasterCard and Johnson & Johnson) spoke positively about growth. US companies are in record-good condition, with extremely strong balance sheets and historically high margins. An increasingly efficient production process is creating sustainable margin improvements, but these have probably now reached their peak. Labour costs are unlikely to fall further, but will instead rise during the current economic upturn, thus wiping out potential margin increases. US corporate executives also had a positive message about capital spending in 2015. There is an increased focus on shareholder-friendly actions that market players will appreciate and reward, for example share repurchase programmes, which lead to fewer outstanding shares and thus higher earnings per share – benefiting shareholders in the form of share price increases.

THE US STOCK MARKET IS BEATING THE WORLD INDEX



Source: Bloomberg

The US stock market (S&P 500) continues to outperform other regions despite high valuations. The US leads the economic cycle, and macroeconomic data are persuasive to investors. This bright picture stands out in a global perspective. American companies are in top shape and reported better overall third quarter earnings than expected. Valuations are high, but strong earnings may justify these share prices.

Market-leading US companies with strong brands in consumer goods, media and IT services will benefit from higher demand, both domestically and internationally. For example, the earnings of sportswear manufacturer Nike are projected to increase by 14 per cent this year and 17 per cent in 2015. A growing middle class in Asia and a growing interest in sports and health will benefit the company. Nike reported sales growth of 25 per cent in Europe and 20 per cent in China in the last quarter. The Internet television network Netflix is adding 1 million new viewers per month, and earnings are expected to grow by a breathtaking 94 per cent this year. Even companies in mature industries, such as General Motors, are showing strong growth thanks to solid demand in China and the Middle East, especially for cars in premium segments.

In the third quarter, US companies showed growth of 10 per cent per share compared to last year. Despite an upturn in the market, the P/E ratio will thus remain unchanged thanks to an upward adjustment in earnings. Earnings growth is expected to be 9 per cent this year, accelerating to 10 per cent in 2015. The P/E ratio for next year will be 16, which seems somewhat high (the 10-year average is just below 14) but as long as companies deliver healthy earnings, higher share prices will be justified despite valuations.

Increased risk exposure

Increased support from central banks in Europe, Japan and China and a strong US economy are providing a solid foundation for continued decent global growth. Macroeconomic data have improved recently, and a stable growth phase for equities is thus our main scenario. In light of this, we are increasing the risk in our portfolios by boosting the proportion of equities. We are focusing on the US and Europe. The US is first in the economic cycle and has the best momentum. The US Federal Reserve recently ended its stimulative bond purchases. Looking ahead, its focus will be on a potential key interest rate hike. This may contribute to increased volatility, but the fact is that equities have historically had a good upswing phase during the period until the first rate hike. In Europe, signals are still a bit mixed but we foresee stabilisation, among other things because weaker currencies are likely to help sustain exports. Europe can also hope for some support from the US in achieving economic momentum.

Assuming sustained strong growth in the US, central bank support measures and cheaper energy, combined with decent valuations, there are reasons to expect equity markets to continue delivering good returns. A long-lasting upturn will also require support from corporate earnings, and we see positive signs there. There are many indications that 2014 will be remembered as yet another good year for equities when the New Year fireworks explode at midnight on December 31.

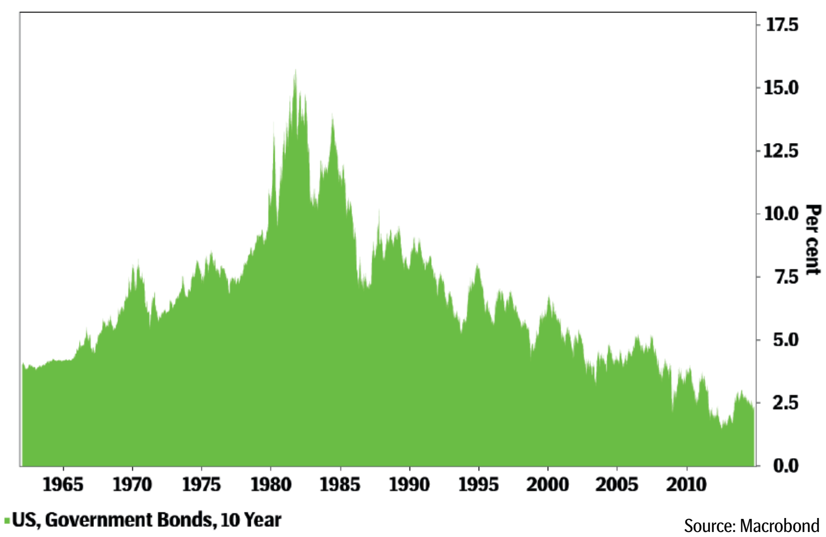
REGION	WEIGHT*	REASONING
Globally	1 2 3 4 **5** 6 7	Global equities will be supported by recent improvements in macroeconomic data and higher growth, which will eventually have an impact on corporate earnings. Higher P/E ratios and share prices will require upward revisions in earnings forecasts and better earnings growth, which we are now seeing signs of in quarterly reports. A stable growth phase for equities is our main scenario.
Europe	1 2 3 4 5 **6** 7	After this autumn's decline in European stock markets, we see potential for upside surprises. Macro data are mixed, but with stable tendencies, and fiscal policy is supportive. We are overweighting Europe in our portfolios, since valuations and earnings growth look attractive. Companies are cost-effective and competitive, and they will benefit from weaker currencies.
US	1 2 3 4 5 **6** 7	The US is leading the economic recovery, and the combination of good growth and support for the US dollar is causing us to overweight this market. Macro data continue to improve and companies are in very good shape, with strong balance sheets and high margins. Valuations are high, but good earnings growth will justify share price upturns.
Asia/EM	1 2 3 **4** 5 6 7	Increased global growth will benefit Asia and emerging markets. Low valuations and good earnings growth are attractive, and we have a positive long-term view. Mixed macroeconomic statistics and weak interest from investors are making us a bit cautious in the short term. We prefer Asia and China to Russia and Latin America.
Japan	1 2 3 **4** 5 6 7	Macro data are improving and fiscal policy is supportive. A weaker yen has benefited exports. Valuations have come down to reasonable levels, but high earnings growth will slow next year. Stock market performance will depend on whether official 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.*

Good returns are becoming harder to find

- **Some central banks are providing more stimulus, others are holding off on tightening**
  Shaky economic growth and the risk of low inflation – even deflation (generally falling prices) – have caused the European Central Bank and the Bank of Japan to expand their monetary stimulus measures. For both the US Federal Reserve and the Bank of England, the next step will be interest rate hikes, but they will put them off for quite a while because of low inflation.
- **Negative yields on European government bonds**
  The ECB's stimulus policy, concerns about economic growth in the euro zone and low or falling inflation due to ever-cheaper oil have led to record-low government bond yields in Europe. Yields on short-term bonds in Germany and Sweden are even negative. In Sweden this is also a result of the Riksbank cutting its key interest rate to zero.
- **High yield bonds and EM debt are the options available for investors searching for returns**
  Because US and European government bond yields are near or below zero, investors searching for returns have to turn to other fixed income markets. Those on offer are high yield corporate bonds and emerging market bonds (EM debt).

UPTURN IN BOND PRICES COMING TO AN END



Source: Macrobond

A bear market for government bonds from the early 1950s to the early 1980s was characterised by rising yields and falling bond prices. This was followed by a bull market which lasted just over three decades, with falling yields and rising bond prices. However, the era of positive yields has come to an end, with today's historically low yields and high bond valuations.

EARLY THIS AUTUMN, FINANCIAL MARKETS were dominated by a blustery mood. The main causes were concerns about economic growth, the International Monetary Fund's downward-revised outlook for the world economy, uncertainty ahead of the US Federal Reserve (Fed)'s phase-out of its QE3 stimulative bond buying programme and continued geopolitical uncertainty with a focus on Ukraine/Russia and Iraq/Syria/the Islamic State.

In late October the markets saw a sharp turn in a positive direction, thanks to a realisation that worries about growth were probably exaggerated, as well as a series of strong corporate earnings reports in the US, and speculation that the European Central Bank (ECB) would begin buying corporate bonds.

As expected, in late October the Fed announced that its QE3 programme was coming to an end. Meanwhile the central bank indicated that it was more upbeat about the US labour market than previously. However, the Fed reiterated that it would keep its key interest rate at a record-low level for a considerable time after the end of QE3. Combined with prospects of far lower US inflation in 2015, this suggests that the Fed may wait until September next year to implement its first rate hike. The Bank of Japan (BoJ) has moved in the opposite direction, expanding its financial asset purchases. The reason for this is a major economic slump in Japan following a consumption tax increase last spring. The BoJ will most likely introduce further stimulus measures next spring.

An important announcement from the EBC in November made clear that ECB Governing Council members unanimously agreed that the bank is prepared to act more forcefully by purchasing bonds and enlarging its balance sheet by EUR 1 to EUR 3 billion. The ECB currently lends money to banks as part of its Targeted Longer-Term Financing Operation (TLTRO), while also buying covered bonds and asset-backed securities (ABSs). But even if the ECB also begins to purchase higher quality corporate bonds, that will be far from enough to achieve its balance sheet target. We are thus forecasting that the ECB will begin to buy government bonds in early 2015.

The Bank of England (BoE) has not changed its key interest rate or the ceiling on its bond purchases for a long time. Judging from lower inflation forecasts in the BoE's November inflation report, the first rate hike may not take place until early 2016. Government bond yields in the US and Europe have trended downward this year as a result of central bank stimulus measures, concerns about the economy, downward-revised growth forecasts, and lower inflation in the wake of falling oil prices, among other factors. Assuming that the ECB and BoJ provide more stimulus this winter and spring and the Fed and BoE hold off on their first rate hikes, government bond yields will probably remain at record lows for a while longer. However, there is little room for even lower yields.

Historically low government bond yields on both sides of the Atlantic – short-term government bond yields in Germany, France and Sweden have fallen below zero, for example – mean that fixed income investors seeking returns must look for them in other fixed income markets.

The high yield (HY) corporate bond segment is still an alternative. Corporate earnings and balance sheets are generally in good shape, and the risk of bankruptcy is not worrisome as long as the economy continues to grow and interest costs are low. Running yields in the HY market are attractive. These may fall somewhat in the short term, with bond prices rising as a result. HY bonds will likely become gradually less attractive in 2015.

The second alternative for investors seeking returns is emerging market (EM) debt, including both government and corporate bonds. To an SEK- or EUR-based investor, for example, interest rates and their fluctuations in local EM currencies – as well as upward and downward currency rate movements – are crucial in determining EM debt returns.

Our crystal ball shows stable to somewhat higher yields on EM bonds in general over the next 6-8 months, although yields in Central and Eastern Europe should move in the opposite direction. Higher yields will allow a number of EM currencies to appreciate against the EUR and SEK. In a longer time frame (8-12 months), there is a risk that Fed interest rate hikes and rising US government bond yields will cause EM bond yields to rise at a faster pace, with a number of EM currencies depreciating against the USD, resulting in lower returns on EM debt.

ASSET TYPE	WEIGHT*	TACTICAL EXPECTED YEARLY RETURN		RISK	
		SEK	EUR	SEK	EUR
Treasury bills	**1** 2 3 4 5 6 7	0%	0.0%	0.1%	0.3%
Government bonds	**1** 2 3 4 5 6 7	0%	-1.1%	4.4%	4.2%
Investment grade corporate bonds	**1** 2 3 4 5 6 7	1.3%	1.1%	2.4%	2.4%
High yield corporate bonds	1 2 **3** 4 5 6 7	5.2%	5.0%	3.8%	3.8%
Emerging market debt	1 2 **3** 4 5 6 7	6.4%	6.4%	8.8%	8.9%

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.*

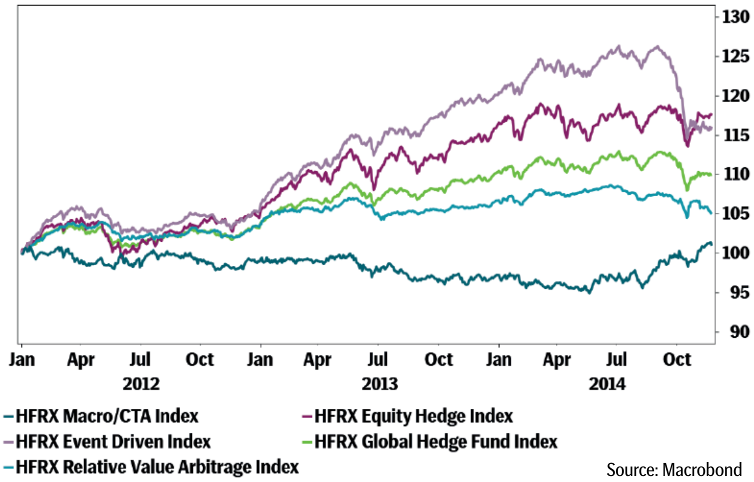
2014 an off year for hedge funds

- **Perception more negative than reality**
  Our perception is that hedge funds have had a bad year, but this is coloured by the fact that European fund managers have had a much tougher time than the global average. In global terms, most hedge fund strategies so far this year have generated positive returns by a margin of several percentage points.

- **Return of the trend-followers**
  "Trend-following" strategies have had a tough time since 2008, but this year they have generated ever-higher returns. As the markets find new equilibrium positions for financial asset prices, these strategies have the potential to generate better risk-adjusted returns.

- **Fundamental value strategies should benefit going forward**
  Market-neutral equity long/short funds have historically generated good returns when the market focuses on company fundamentals rather than on macroeconomic trends. Usually this occurs in the latter part of the expansion phase in a business cycle, which in our view is where we currently are.

POWERFUL REVENGE FOR TREND-FOLLOWING CTA STRATEGIES



Source: Macrobond

The pattern we have been accustomed to in recent years, with event-driven strategies on top and CTA (trend-following strategies) on the bottom, came to an end this autumn. CTA strategies have shown the best performance lately, while event-driven ones have performed the worst since the summer. As the chart indicates, the other three strategies have trended flat to falling. It is worth noting that all five strategies have posted positive returns since the turn of the year.

TODAY HEDGE FUNDS ARE A TYPICAL HOLDING in the portfolios of both institutional investors and private individuals. Since this asset class offers all kinds of risk exposures, investors should therefore consider what they want from their investment when they allocate capital to hedge funds. If they are looking for a diversified return that is independent of traditional investments in equities and bonds, they should choose strategies with a low correlation to equities, so-called market-neutral strategies.

Although the environment for generating alpha (the return a manager generates in excess of the relevant benchmark index) has been challenging in 2014, most strategies have generated positive returns. European fund managers have encountered greater headwinds than the global average, which has led to the perception that this asset class has had a bad year. Globally, the appetite for hedge funds remains good, although in Europe there is more of a wait-and-see attitude given the weaker performance there this year. The market is still dominated by central bankers' implicit guarantee to do "whatever it takes" to boost growth. The US has clearly signalled through the Federal Reserve that it is ending its stimulus, whereas the European Central Bank (ECB) and the Bank of Japan (BoJ) will continue to bolster the market's risk appetite.

As in most years, the financial markets have also seen unexpected events in 2014. Most market players have been positioned for rising long-term yields and interest rates, but these have not materialised. Strong sector rotations have also dominated the stock market, which has been tough for many fund managers. In contrast, strategies with some degree of underlying market risk were able to benefit from this market. Hedge funds focusing on debt have generated good risk-adjusted returns in recent years. Credit (yield) spreads have gradually narrowed, and the substantial gains from holding long positions are now behind us. We prefer fund managers who are actively looking for both long and short positions.

Equity long/short

A large proportion of funds in this segment are "long-biased", that is, they have a majority of long positions and are thus dependent on how the stock market performs. For investors who want equity exposure but believe the risk is too high, funds with good risk management in this segment are a good alternative. Market-neutral funds in this segment usually generate good returns when the market is more focused on company fundamentals than on macroeconomic trends. That usually occurs during the latter part of the expansion phase of a business cycle, which in our view is where we currently are.

Relative value

Low yields and interest rates, narrow credit spreads, a relatively strong stock market and the massive influence of central banks have been a challenge for this type of hedge funds. The same trend will probably continue next year as well. Meanwhile we expect the co-variation between individual securities and asset classes to fall, creating opportunities for these strategies.

Event-driven

Event-driven funds have generated positive returns in 2014. However, this segment has not lived up to the high expectations fuelled by increased corporate transaction activity. One contributing factor was US Congressional plans to make it impossible for American companies to acquire European ones in order to achieve tax advantages. Other arguments based on fundamentals that favour a good performance for these strategies in 2015 are still valid – low interest rates and yields, large corporate cash reserves, continued capital flows into the stock market and investors that reward both acquisition candidates and their buyers. We also expect continued strong pressure for initial public offers, corporate transactions and restructurings going forward.

Macro/CTA

Our view is that the markets are normalising and that global macro strategies should perform well next year. Central banks are careful in signalling their intentions to the market, resulting in fewer unexpected policy decisions. Uncertainty about the European banking system has eased, and the new political leadership in China has become established. We also have a world with great regional differences in economic growth, which is a good environment for global macro strategies.

We believe the environment for trend-following strategies (CTA) will be more favourable going forward than it has been for the past few years. As the world's central banks gradually relinquish control and let the market set financial asset prices, there will be better potential for clear asset price trends.

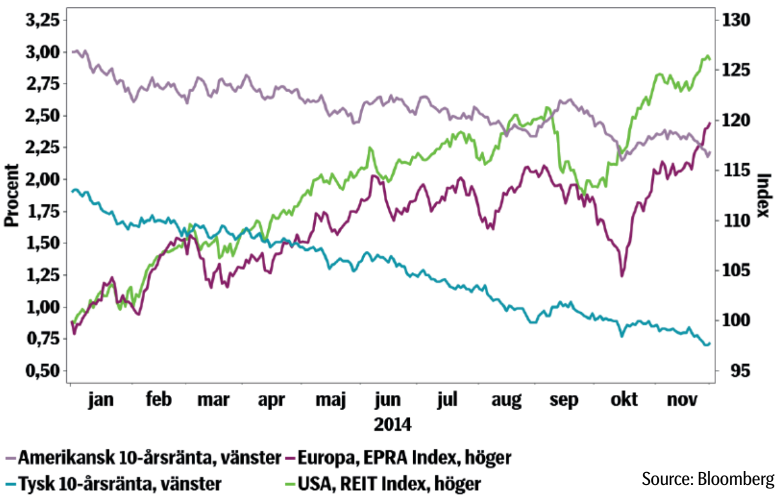
STRATEGY	INDEX	PERFORMANCE IN % (USD)					
		1/1-20/11 2014	2014 Q3	2013	2012	2011	2010
Global hedge	HFRX Global Hedge Fund	-0.4	2.1	6.7	3.5	-8.9	5.2
Equity hedge	HFRX Equity Hedge	1.0	1.2	11.1	4.8	-19.1	8.9
Relative value	HFRX Relative Value Arbitrage	-1.7	0.8	3.0	3.6	-4.0	7.7
Event-driven	HFRX Event Driven	-3.6	2.3	13.9	6.0	-4.9	2.0
Macro/CTA	HFRX Macro/CTA	3.8	2.9	-1.8	-1.0	-4.9	-1.7

Source: SEB

High activity and increased competition

- **Continued high activity is being bolstered by low bond yields and brighter prospects**
  There is still a high level of activity in the global real estate market, driven mostly by the US and Europe. However, in Asia, we are seeing somewhat lower activity than in 2013.
- **Falling vacancy rate for office space**
  With a falling vacancy rate and a delay before the first big wave of new construction reaches the market, the market for office space is expected to remain strong.
- **REIT market is back at high levels**
  After a correction related to turbulence in the financial markets in October, both European and US real estate investment trusts (REITs) have recovered lost ground.

REIT MARKET BACK AT LATE-SUMMER LEVELS



Source: Bloomberg

This autumn's turbulence in the financial markets did not go unnoticed in the REIT market. But after an October correction, which was on a similar scale to the stock market's, REITs have now recovered lost ground and are again trading at the same levels as before the autumn worries.

DESPITE UNCERTAINTY ABOUT general economic conditions and the geopolitical situation, activity in the global real estate market remains high. Investments in this market continue to attract different kinds of investors regardless of geographic location, sector or size.

Low bond yields combined with less volatility in the stock market partly explain why global growth in direct investments in the commercial property market is expected to reach around 20 per cent in 2014, compared to 2013. Despite its strong growth this year, our view is that the market will continue to grow steadily in 2015, although at a somewhat slower pace.

Growing competition in primary markets (attractive metropolitan areas), together with a continued favourable funding climate, suggests that some investment activity in 2015 will shift towards secondary markets, where return requirements have not been squeezed to the same extent.

From a geographic perspective, the US is a positive stand-out. Transaction volume growth for the first three quarters of 2014 is up 36 per cent, compared to the same period last year. China, on the other hand, has seen commercial transaction volume fall by over 30 per cent this year compared to last year. General concern about the country's economic trend and measures to rein in lending are believed to be factors behind this development.

One segment where conditions are considered especially favourable is the market for office space. The global vacancy rate has fallen below 13 per cent for the first time in a long while, which in itself signals a supply shortage. In response, new construction has quickly accelerated globally and is expected to be 25 per cent higher in 2015 than in 2014, with potential for even stronger growth in 2016. However, there is a significant time lag between today's falling vacancy rates and the 12-18 months needed for the first major wave of new construction to reach the market, which suggests that rent increases are in store. Heavy interest in this type of investment is also reflected in valuations and return requirements. With only one month left in the year, most factors point to valuations of quality assets in larger markets rising 8-9 per cent this year.

Shrinking return requirements on this type of investment also indicate great interest and activity. One of the few exceptions among primary markets is Moscow, where economic uncertainty and geopolitical tension have instead led to growing return requirements. It is noteworthy from a European perspective that cities in the GIIPS countries (Greece, Italy, Ireland, Portugal and Spain) such as Madrid, Barcelona, Milan and Dublin show lower return requirements.

There is also considerable activity in the global hotel market. The underlying stable rate of revenue growth in this sector has attracted investors; meanwhile lender confidence has returned. Among investors alert to the potential of hotel investments are private equity (PE) companies. Although PE companies invest in the entire spectrum of properties, their interest in hotels seems especially great in 2014. For example, this category of investors accounts for the largest percentage of purchases in North America measured in volume.

Nonetheless, future prospects are not entirely risk-free. Geopolitical developments in the Middle East, worries about the spread of the Ebola virus and uncertainty about the European economic recovery are all factors that may dampen investment interest in the hotel segment.

With three quarters of the year now past, most indications are that 2014 will be a good year for real estate. Despite this year's strong performance, there is potential for 2015 to be another strong year. The market for real estate investment trusts (REITs) saw a correction in October as a result of worries about global financial markets. But, like the stock market, it has experienced a strong recovery. This means that the US and European REIT markets are both trading at the same levels as before these worries. Underlying economic growth combined with weakly rising bond yields and interest rates may very well foster continued strength and growth in the REIT market. However, beware if rapidly rising interest rates and yields enter the picture or there are signals of deteriorating prospects for Europe's economic recovery.

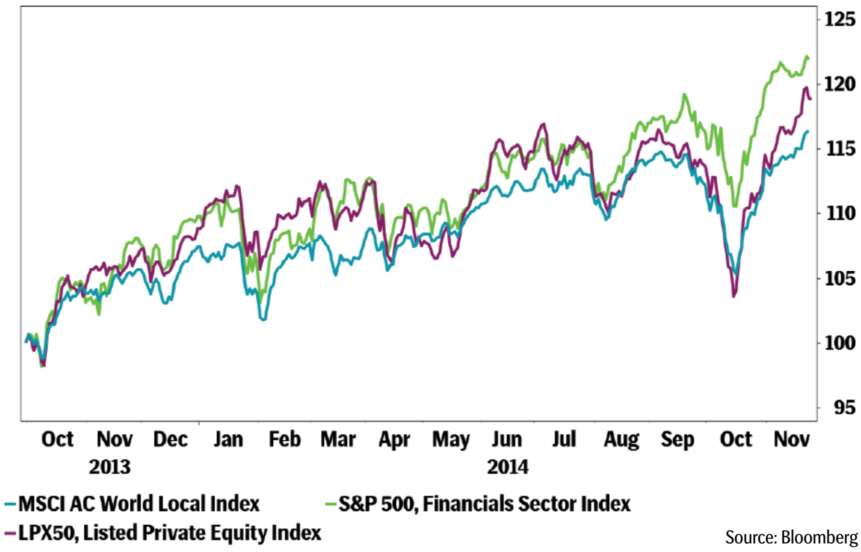
Bright prospects, but challenges on the horizon

- **Continued support from economic recovery and stimulus measures**
  US economic growth and recovery – together with expanded monetary stimulus in the euro zone, Japan and China – will provide a good basis for continued strong activity.

- **Tougher competition and regulatory requirements mean longer transaction times**
  Increasingly stringent regulatory requirements for transparency and documentation mean that more resources are needed for each deal, which in turn leads to longer transaction times.

- **Institutional investors are choosing to invest directly**
  Some major institutional investors that previously used private equity companies for their investments now tend to be open to the idea of direct investments using in-house talent.

STRONG RECOVERY FOR PRIVATE EQUITY



Source: Bloomberg

The broad index for private equity (LPX50 Total Return in EUR) has not only recovered from the correction this autumn, but in recent weeks it has also seen a sustained uptrend – outperforming the stock market.

THERE IS STILL GOOD POTENTIAL in the private equity (PE) market due to the US economic recovery and increased central bank stimulus measures, mainly in the euro zone and Japan. The stable transaction activity seen early in the year has continued, supported by ample funding potential and good divestment opportunities. All in all, this points to good potential in the private equity sector for quite a while. Yet while prospects are bright, based on the state of the underlying economy, there is no lack of challenges of a more structural nature.

The combination of favourable terms for raising capital and limited investment opportunities has created an environment of increasingly fierce competition between market players. That in turn has led to rising company valuations, and as a result companies are sitting on record cash holdings. This combination of relatively high valuations and substantial cash reserves suggests a further rise in prices.

But it is not just limited investment opportunities and higher valuations that are making life more complicated for PE companies. Like other financial markets players, this category of companies also faces tougher regulatory requirements. In the past, PE companies were subject to more limited oversight by authorities, and the companies instead embraced a kind of self-policing. Today a different mood prevails, and companies are increasingly being forced to meet more stringent oversight requirements and provide more detailed reports and more extensive documentation.

That is another reason why the average time needed to complete a transaction has increased over the past year. The extensive due diligence (investigation/analysis of a company) carried out prior to a transaction must now also comply with new regulatory requirements. This makes the process more complex and time-consuming. Another reason for the longer transaction times is connected to higher valuations. In the aftermath of the global financial crisis, PE companies have become increasingly careful not to make flawed analyses prior to investing, which in itself requires putting greater effort into each deal. Aside from longer transaction times, these increased efforts also entail higher costs, for instance increased staff resources.

An additional reason why the competition may become tougher is a trend we have seen in recent years: institutional investors such as government investment and pension funds choosing to make their own direct investments instead of investing via PE companies. This category of investors, historically among the largest in this market segment, has started to build up its own organisations for this type of investment. The main reason is to avoid the fees charged by PE companies. These investors also believe that they can deliver the same kind of service by using their organisation's in-house talent. However, that fact alone is not the main reason for the price increase; instead, it is the differences in leveraging ratios, time horizons and return requirements between PE companies and direct investors.

The time horizon for an investment carried out by a PE company is normally about 10 years, with an investment period of 5 years and a debt to EBITDA (earnings before interest, taxes, depreciation and amortisation) ratio of 7-9. The targeted return on the investment in many cases is an internal rate of return (IRR) of 25 per cent and a divestment price upon exit of three times the capital invested. A government pension fund, on the other hand, may have a far longer investment horizon and a considerably smaller need for leverage, if any.

The result of this is a lower return requirement, which indirectly allows PE companies more leeway for higher prices at the time of the initial investment. Since there is less leverage, this will probably increase the likelihood of their riding out storms in the financial markets.

Historically, PE companies have proved to be skilled at adapting to changes. With this experience in mind, it is too early to express a clear opinion on the effects of the regulatory changes now under way.

However, it is clear is that the world is in a low bond yield and low interest rate environment, where investors are being pushed further out on the risk scale in their efforts to generate returns.

Private equity companies with large cash reserves, good funding potential and record-level exit activity should therefore continue to be a strong investment alternative.

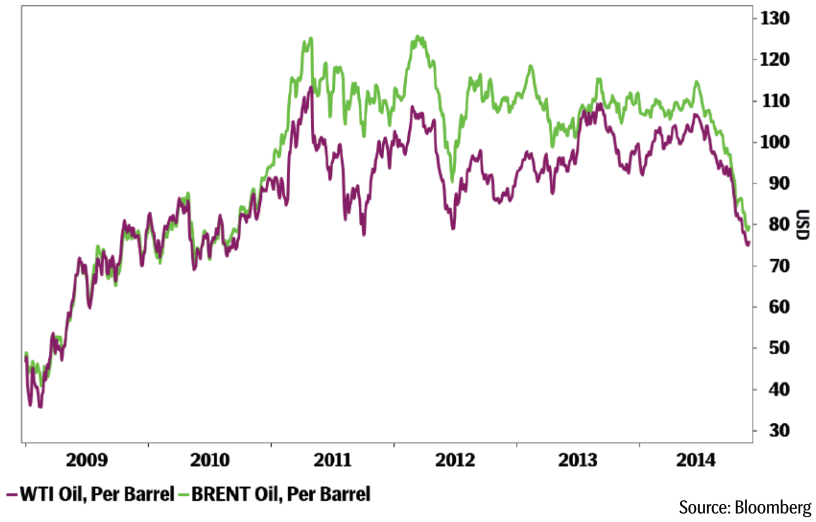
Lower oil prices providing global stimulus

- **Oil prices have continued to fall this autumn**
  Oil consumption forecasts have been successively lowered this year. Combined with increased US production, a return to more normal production levels in Libya and the unwillingness of the Organisation of the Petroleum Exporting Countries (OPEC) to lower production to achieve market balance, this explains the big decline in oil prices during 2014.

- **Shortages in several metal markets over the next few years**
  We expect shortages of both nickel and aluminium in 2015, while the copper market will shift from its current surplus to a shortage only in 2017. This will help to sustain price increases. We expect higher metal prices next year.

- **After four years of falling prices, we now expect an upturn for agricultural commodities**
  Ever since the price rally for agricultural ("agri") products during 2010, the trend has been downward. After an initially weak trend this autumn, prices are at the levels that prevailed before 2010. We believe that the decline is now over and expect somewhat higher prices ahead.

OIL PRICES AT FOUR-YEAR LOWS



Source: Bloomberg

OPEC's strong aversion to production cuts, combined with lower global demand and higher supply than forecast, has led to sharp oil price declines. Although we believe that oil prices will be somewhat higher a year from now, we feel that there is a relatively high probability that prices will first become lower before becoming higher. OPEC's actions will determine the near-term price trend.

EXPRESSED IN USD, MOST METAL PRICES have fallen this autumn, but because the US currency has appreciated sharply at the same time, several metals are more expensive today – for example in Swedish kronor terms – than three months ago. During the past quarter, copper has become more than 4 per cent cheaper in USD. Because new production is gradually going on stream, we expect a surplus in the copper market during 2015-2016 but believe this will change to a deficit as early as 2017. We thus anticipate somewhat higher copper price next year. Economic developments, especially in China, will be very important to copper prices.

Even though the ban on exports of nickel ore from Indonesia (which accounts for 20 percent of global production) is still in place, nickel prices have fallen this autumn and are now at the levels prevailing before the export ban was introduced. Increased exports from the Philippines have partially offset supply shortages, but this ore has a lower nickel content. Overall, our conclusion is that nickel prices should be at levels well above current prices during the next few years. We also anticipate shortages of aluminium next year and somewhat higher prices, although the potential is less than for nickel.

Gold prices rose somewhat in early October due to increased market turmoil, but since then they have fallen again. At this writing they are lower than at the beginning of 2014. We do not anticipate any major movements in gold prices over the next year, but looking ahead a few years we believe that USD 800-900 per ounce will not be unreasonable. This represents a downturn of around 20 per cent. Rising inflation expectations would potentially change this picture.

After South African mining strikes and European economic conditions led to more downside than upside surprises, the price trend for platinum was weak throughout the summer and autumn (platinum is in demand among automotive manufacturers in Europe). Since they peaked in mid-July, platinum prices have fallen by 20 per cent. We see some potential for a price upturn during the coming year, assuming that the European economy does not disappoint us. Rising palladium prices seem more likely, however, supported by falling global stocks but also by increased demand for petrol-powered cars (palladium is used as a catalyst in these). The ongoing troubles in Russia will also affect price developments, since the country accounts for about 45 per cent of global palladium production.

After the extremely strong autumn 2010 upturn in prices of agricultural products due to the La Niña and El Niño weather phenomena (prices doubled), our recurrent assessment has been that prices should fall. Aside from price increases in early summer 2012 and in spring 2014, our assessment has been correct. After a good summer harvest led to further price declines, in late September prices reached levels we had not seen since the summer of 2010. Our current assessment is that prices have stopped falling, and we see some potential for increases.

After the impact of the Chinese stimulus package launched during the financial crisis began to fade, most metal prices fell relatively sharply. Yet oil prices remained high: USD 90-110 per barrel from early 2011 until early summer 2014. Among the reasons was lower production in various parts of the world due to geopolitical turmoil and sanctions. But since early summer, oil prices in USD terms have fallen by almost 30 percent (Brent crude) to levels last seen in 2010.

Because the economic recovery has been slower than expected and forecasts of global oil consumption growth have gradually been lowered, supply has also increased more than we previously forecast. The growth of US shale oil output has probably surprised most observers. Total US oil production is now around 9 million barrels per day (including about 4 million barrels of shale oil), compared to some 5 million barrels per day in 2009. In addition, some of the earlier decline in oil production is now history. For example, as recently as last April production in Libya was 200,000 barrels per day. Today it is around 900,000 barrels per day, and there is still room for it to increase, since historically normal levels are about 1.5 million barrels per day. In addition, Iran is now producing about one million barrels per day less than normal.

ASSETS	WEIGHT*	REASONING
Energy	1 2 **3** 4 5 6 7	Slower economic recovery and a faster increase in oil supply, combined with OPEC's unwillingness to lower production, have caused about a 30 per cent slide in oil prices. We expect somewhat higher prices next year, but oil may become cheaper before it becomes more expensive.
Industrial metals	1 2 3 4 **5** 6 7	We expect shortages of both nickel and aluminium next year. There will not be a copper shortage until 2017. This should lead to higher prices for these metals. We believe that nickel has the potential to climb the most.
Precious metals	1 **2** 3 4 5 6 7	Due to the end of strikes in South African mines, combined with weaker European economic performance than forecast, we do not expect large price increases for platinum. Palladium looks attractive, for example because of greater demand for petrol-powered cars. We foresee rather substantial room for gold prices to decline over the next several years.
Agricultural	1 2 3 **4** 5 6 7	After about four years of falling prices for agricultural products, we now believe there is potential for somewhat higher prices.

** "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.*

In the last issue of *Investment Outlook*, we estimated that oil prices would be around 100 USD per barrel in 2015 but said that this assumed lower OPEC production and that the main risk was lower oil prices. In hindsight, today we can note that OPEC is continuing to produce at full throttle – currently about 31 million barrels per day, of which Saudi Arabia's share is about 10 million barrels. Today's OPEC production level is the second-highest figure in the past five years. Defending national market shares despite lower oil prices has been OPEC's focus to date.

How much lower can oil prices go? The production cost of oil produced outside OPEC averages about USD 60 per barrel. The cost within OPEC is considerably lower: perhaps as low as USD 10 per barrel. Saudi Arabia, which accounts for one-third of current OPEC production, has proved uninterested in reducing production. Our conclusion is that the country probably wants to force other OPEC members to the negotiating table to establish clear quotas. Otherwise the Saudis want to reduce competition from shale oil.

The next OPEC meeting took place on November 27 (after this publication went to the printer) and will thus be very important for the oil price trend in the near future.

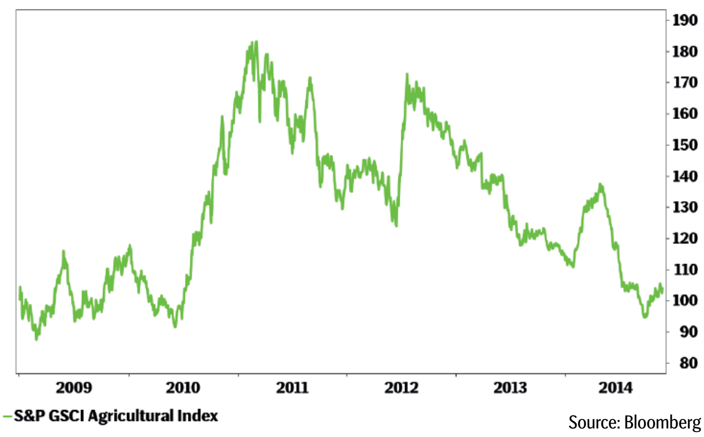
What will be the impact of lower oil prices?

During 2007 and the first half of 2008, we experienced a doubling of oil prices. Industry observers wrote articles and talked about "peak oil" and all the challenges we were facing related to world energy supply, especially for the transport sector. What would happen when more and more Chinese bought cars? But during the second half of 2008, oil prices fell all the way to the levels prevailing before the increase in 2007. Worries faded, at least temporarily. Since 2011, Brent oil prices have fluctuated between USD 90-110 per barrel. We would probably all have become accustomed to this and adapted to oil prices of around USD 100 per barrel. But early this past summer, prices began to fall. Since peaking in June, oil is nearly 30 per cent cheaper.

The future will tell whether these lower oil prices will be long-lasting or not, but if this is the case it will have an impact. According to the International Monetary Fund (IMF), an oil price change of 20 per cent has approximately a 1 percentage point effect on global GDP, including all the secondary effects such as interest rate movements. Assuming that low prices continue, this could add almost 1.5 percentage points to global GDP growth. Countries that are major oil exporters will be the losers, while importers will be the winners. Russia, whose economy is dependent on oil, is one of the big losers. A one dollar change in the price of a barrel of oil has an impact on the Russian economy totalling USD 2.3 billion per year. In Venezuela, oil accounts for about 95 per cent of total exports, so major price declines will lead to fiscal challenges for the country.

Although the percentage of alternative vehicles (gas- and electric-powered cars) has increased, oil remains the most important transport fuel. In the US, where households are large consumers of petrol (gasoline), one rule of thumb is that for every cent per gallon that petrol prices fall, overall room for consumer spending increases by a billion dollars. Since the price of petrol in the US today is about 70 cents per gallon lower than last summer, this should have a substantial impact on consumption this holiday shopping season.

With lower oil prices, there is also a risk of adverse effects in terms of increased geopolitical imbalance and downward adjustments in inflation expectations. Companies operating in the oil industry or in related businesses are of course adversely affected. Because of this autumn's sharp appreciation in the dollar, the decline in oil prices expressed in currencies other than the USD has not been as dramatic.



Source: Bloomberg

AFTER FOUR YEARS OF FALLING PRICES, THERE IS NOW POTENTIAL FOR HIGHER AGRICULTURAL PRICES

The sharp price increases for agricultural products due to weather phenomena during the autumn of 2010 were followed by four years of falling prices. Good harvests this past summer, resulting in further price declines, have led to our assessment that the decline in prices is over. We anticipate somewhat higher prices ahead.

Central banks still driving the FX market

- **Monetary tightening and healthy US economic growth will bolster the dollar**
  The US economy is still growing at a healthy pace, and the Federal Reserve will introduce rate hikes next year. This will strengthen the US dollar against the euro and Japanese yen, which will fall in value as a result of weak economies and further monetary stimulus measures.

- **The Swedish krona and Norwegian krone will appreciate against the euro in 2015**
  In 2014, the Swedish krona has been weighed down by disappointing economic data and cuts in the country's key interest rate to zero, while the Norwegian krone has weakened as oil prices have plunged. In 2015, both currencies are expected to appreciate against the euro.

- **Rapidly shifting trends for EM currencies**
  Emerging market (EM) currencies as a group have the potential to strengthen this winter, before once again weakening. The prospects for individual EM currencies vary considerably, with Asian currencies having the best potential to appreciate in the short term, while a number of Eastern European currencies should weaken.

ARGUMENTS FOR FURTHER WEAKENING OF THE YEN

Source: Macrobond

Since Japanese Prime Minister Shinzo Abe launched his economic strategy known as "Abenomics" in the winter of 2012/2013, the yen has trended lower against the US dollar. This weakening is part of Abe's strategy and, aside from boosting competitiveness and growth in Japan, it will lead to more expensive imports and thus higher Japanese inflation (the official target is 2 per cent). Now that the country has once again fallen into recession in 2014, the Bank of Japan will probably follow the example of the Abe government and launch more stimulus packages – with a further weakening of the yen as a consequence.

OUR OUTLOOK FOR MAJOR WORLD CURRENCIES in 2015-2016 remains unchanged. In other words, we expect the **US dollar (USD)** to strengthen, while the **euro (EUR)** and **Japanese yen (JPY)** will weaken. The arguments for such a scenario are essentially the same as they were three months ago.

The US economy continues to grow at a healthy pace while the Federal Reserve (Fed), having phased out its QE3 bond purchases at the end of October, will start raising its key interest rate in September 2015 according to our current forecast.

Meanwhile, the euro zone and Japanese economies will grow very slowly over the next few years, and both the European Central Bank (ECB) and the Bank of Japan (BoJ) will keep their key interest rates close to zero for at least another couple of years. The two central banks are also expected to expand their financial asset purchases. In the ECB's case, our forecast is that it will launch a government bond-buying programme in early 2015, which would be necessary in order to achieve the central bank's goal of expanding its balance sheet by EUR 1 billion to EUR 3 billion.

The BoJ is expected to launch further asset purchases, including government bonds, corporate bonds and exchange-traded funds (ETFs), with the aim of increasing its total asset purchases from the current JPY 80 trillion per year to JPY 100 trillion. Another detrimental factor for the value of the JPY is the Japanese Government Pension Investment Fund (GPIF)'s recent decision to reduce the share of Japanese bonds in its portfolio from 60 to 35 per cent and instead increase the weighting of domestic and foreign equities.

As for the **British pound (GBP)**, the Bank of England (BoE) has changed its forward guidance on a number of occasions, causing players in the foreign exchange (FX) market to revise their estimates several times this year as to when the BoE will initiate its rate hikes.

During the summer and early autumn, verbal signals from BoE Governor Mark Carney and the fact that two of the nine Monetary Policy Committee members voted at several meetings in a row to raise the central bank's key interest rate indicated that the first rate hike would come in early 2015. The most recent message from the BoE in its new inflation report was that British price increases look set to be far lower in 2015-2016 than previously assumed. SEB is therefore now predicting that the first rate hike will not be implemented before early 2016. This means that the appreciation of the GBP against the SEK that we expected earlier is not likely to occur.

The **Swedish krona (SEK)** weakened when the Riksbank cut its repo rate to zero in late October, but the decline in the value of the SEK, as after the rate cut in July, was temporary – a reflection of the FX market having already discounted a weak krona. If the Riksbank does not launch further stimulus measures, the SEK may stabilise this winter and then appreciate in 2015-2016 against the EUR.

The outlook for the **Norwegian krone (NOK)** is more uncertain. Even though Norway's economic fundamentals are clearly very strong, inflation is close to target and the mainland economy is rather robust, the decline in oil prices is hitting the country's oil sector hard. Our main scenario is that the Norwegian central bank will not have any reason to lower its key interest rate and that the NOK will continue to trade in a rather broad range against the EUR for a while. In 2015, we predict that the NOK, like the SEK, will strengthen against the EUR.

After a steep decline in several phases since the summer of 2011, **emerging market (EM) currencies** as a group – for example, as reflected in the JP Morgan Emerging Markets Currency Index – have apparently become undervalued against the USD. Despite this undervaluation, EM currencies are continuing to weaken right now – a trend we expect will soon reverse, however. Thanks to low US inflation, the Fed's first rate hike will be delayed until early autumn 2015. Combined with a gradual strengthening of EM economies, this will give EM currencies a chance to appreciate over a time horizon of around four months.

However, prospects vary for the different EM currencies. Many Asian currencies have very good potential to strengthen over about the next six months, as do some currencies in Latin America (mainly the Mexican peso, MXN). Meanwhile a number of Eastern European currencies will probably be carried along by the EUR and will weaken; one exception may be the Polish zloty (PLN).

Once the Fed begins its tightening cycle and US government bond yields rise more substantially, there is a greater likelihood that EM currencies will once again fall in value. However, significant differences will persist over the long term between the opportunities and challenges of individual currencies.

Among the currencies of the BRIC countries (Brazil, Russia, India and China), the Chinese yuan (CNY) has the best potential to rise in value over the next year or so, despite a cut in the country's key interest rate. China still has a large current account surplus, and the pace of growth there is still comparatively high. The Indian rupee (INR) – even taking potential rate cuts into account – may hold its own against the USD reasonably well as a result of brighter economic prospects, credible reform policies and a narrower current account deficit.

Despite a sharp fall in value, there is still a downside for what is now essentially a floating Russian rouble (RUB), which will also probably remain extremely volatile. Russia's economy is entering a recession, and there is still a great risk of continued capital outflows from the country related to geopolitical tensions. The Brazilian real (BRL) also looks set for a bumpy ride over the next year. The Brazilian economy is in bad shape, falling commodity prices are unfavourable to the country and there is widespread lack of confidence in the power and potential of re-elected President Dilma Rousseff to get the Brazilian economy on the right track.