PRIVATE BANKING • INVESTMENT STRATEGY

# Investment Outlook

## September 2015

SEB

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# China's erratic performance causing great market turbulence

**DURING THE SUMMER, SIGNS OF** growth improvements in Europe and the United States collided with the opposite signals from China. The government of China is seeking to shift the economy from an investment-led model to one that is more similar to the Western consumer-driven variant. This changeover is taking place at the same time as the growth rate is gradually slowing. China and other emerging market (EM) countries also represent a significant percentage of the world's production capacity, but this EM "factory" is suffering from squeezed margins. The consequences of restructuring and deceleration are evident in many places: in Chinese economic statistics, world trade volumes, commodity prices and local corporate profits as well as in companies that export to China. This is not a new phenomenon, though; the same trend has been under way for several years.

During the summer these developments triggered very large investor worries, which in turn resulted in a sharp correction in all asset markets. This can be interpreted as obvious concern about global growth and a possible crisis in the emerging market sphere.

This issue of *Investment Outlook* includes three theme articles. Two of them are linked to EM regions: we examine China and India. What are conditions like in these countries, and how will they affect the rest of the world and the financial markets? Our third theme article is connected to the United States and its central bank's planned key interest rate hikes. It has now been more than a decade since the Federal Reserve last began a rate hiking cycle. How do we view this process and its implications?

*Investment Outlook* also includes an update of how we view economic growth. Will global growth accelerate in the way central banks have been hoping, during the many years they have helped sustain the economic system by means of low interest rates and very aggressive monetary policies? This is an important parameter for our view of the potential of various asset classes. The question of how the recent major stock market declines have affected share valuations is also discussed in various places in our report.

Finally, we discuss what risks we regard as the most significant in the near future.

Wishing you enjoyable reading,

**FREDRIK ÖBERG**
*Chief Investment Officer*
*Private Banking*

# Market view

## Summary

- We still expect economic growth, though China is sending weaker signals.
- Central banks will help, with low interest rates and added liquidity.
- After market declines, valuations are more attractive.
- We prefer equities and corporate credits to government bonds.
- Hedge funds will stabilise portfolios.

**Recent sharp stock market declines** and rising yields on credit instruments are a sign of mounting uncertainty about growth potential, which immediately leads to a questioning of financial asset prices and their valuations relative to each other. As a rule, this type of setback leads to calls for greater future risk compensation (lower price/earnings ratios). If downturns should continue on a large scale, asset pricing will signal that we moving towards a new economic slowdown.

In our judgement, we are not facing an economic slump. Instead, we view the recent major stock market slide as a collective expression of investor worries about slower future growth and greater emerging market (EM) risk. It is clear that China's transition from an investment-driven towards a more consumer- and service-oriented model has created some problems for sectors and companies that are exposed to the old model. For example, this applies to commodity producers, for which both demand and prices have moved in the wrong direction.

In our view, financial market players have now obviously adjusted their expectations, but the near future will offer accelerating US and European growth as well as a continued EM slowdown. If we assume that annual global growth in the next two years will be around 3 per cent, this ought to result in a potential earnings increase of around 5-8 per cent for the global business sector. Companies should still be able to pay dividends of around 2-3 per cent. Given these assumptions, equities and corporate credit instruments should provide higher returns than other investment alternatives.

After the sharp correction of recent months, we expect volatility to persist for a while, since investors will be more watchful and cautious. Risk appetite has plunged. Periods like this also demonstrate the continued need to diversify risks, although this is easier said than done since many assets behave similarly and traditionally defensive positions offer very low expected returns.

## MAIN STRATEGIES IN OUR PORTFOLIO MANAGEMENT

### Turbulence does not change our basic view

To some extent, developments in China and other emerging markets are disrupting our cautiously positive economic view, but not enough to make us change our opinion. Assuming that the US, Europe and perhaps also Japan are on the right track, global growth in the coming year should end up in the 3-4 per cent range. Inflation remains very low, and various major central banks will pursue expansionary monetary policies. This suggests a suitable environment for businesses to operate in and should lead to higher earnings. It should also keep down market interest rates and bond yields. This would imply that exposures to the corporate sector are preferable to equivalent sovereign exposures. The recent major correction has also helped eliminate some of the earlier questions about equity and corporate bond pricing and valuations.

### Risks

Just as during the modest growth of recent years, it is obvious that an economic slump would cause problems. The most recent statistics from China show weakness, so the risk that markets have reacted to is real, although we believe that the reaction is a bit exaggerated. Another risk is low commodity prices and their consequences. If current price levels should persist, the proportion of defaults and problem loans in highly commodity-dependent companies and countries will rise. Finally, we cannot dismiss the risk of asset price bubbles either.

### We prefer Europe to Emerging Markets

For some time, we have advocated a portfolio that is consistent with our fairly positive economic view. We give higher priority to developed market than emerging market equities, with an emphasis on Europe. We still believe in a stronger dollar, and as a result of large stock market declines, valuations also now look more attractive in the US. Overall, however, we have underweighted the US stock market in our global portfolio. Asian equities also look attractive from a valuation perspective. The Swedish stock market is a concentrated version of the world economy and usually works well as long as the economy stays healthy and valuations are not too high, which is not the case. Among alternative investments, we seek investments with low correlations to equities and corporate credit instruments.

| ASSET | WEIGHT | TACTICAL EXPECTATION (12-MONTH) | | REASONING |
|---|---|---|---|---|
| | | RETURN | RISK | |
| **EQUITIES** | | | | |
| Global | 1 2 3 4 5 **6** 7 | 8.2 % | 12.1 % | Adequate growth, some idle capacity and a corporate sector that has been enacting efficiency-raising measures for years will provide potential for higher earnings. A still-difficult pricing situation will counteract this. Valuations have now fallen and again look more attractive. |
| Emerging markets | 1 2 3 **4** 5 6 7 | 6.2 % | 14.3 % | Weaker EM economic performance and sluggish international trade will have a negative impact, while valuations compared to the rest of the world are a plus. Heavy commodity dependence, the negative impact of a strong US dollar and rising US interest rates will be minuses. Commodity-exporting countries will be attractive only when we see pricing stabilisation. |
| Swedish | 1 2 3 4 **5** 6 7 | 13.0 % | 13.6 % | The weak krona combined with our view of global growth and a stable domestic situation will provide strength. In international terms, dividend yields are high. Second quarter earnings were helped by favourable exchange rates. Further ahead, there are clear risks connected to the real estate market and future high interest rates in Sweden. |
| **FIXED INCOME** | | | | |
| Government bonds | 1 **2** 3 4 5 6 7 | -2.6 % | 4.2 % | Due to very low government bond yields, portions of the bond market are unattractive. Strong economic conditions may lead to gradually rising yields over the next few years, with a risk of negative returns. |
| Corporate bonds, investment grade (IG) | 1 2 **3** 4 5 6 7 | 1.2 % | 2.4 % | Low yields provide low potential, but this asset type may work well in a portfolio that includes other higher-risk assets. |
| Corporate bonds, high yield (HY) | 1 2 3 **4** 5 6 7 | 3.5 % | 3.6 % | Yields of 3-5 per cent stand out in the fixed income world, but as a consequence there is also clearly higher risk than with IG bonds, for example. In some segments, the proportion of bankruptcies will rise as an effect of low commodity prices, but this is discounted in market pricing. |
| Emerging market (EM) debt | 1 2 **3** 4 5 6 7 | 7.1 % | 9.5 % | Yields of around 6 per cent are high, but risks have increased due to developments in emerging markets. |
| **ALTERNATIVE INVESTMENTS** | | | | |
| Hedge funds | 1 2 3 **4** 5 6 7 | N/A | N/A | Lower volatility, combined with the opportunity to generate returns even from negative trends and in assets that do not have a strong correlation with equities and corporate credit, make this asset class attractive as a complement in a portfolio. |
| Commodities | 1 2 **3** 4 5 6 7 | N/A | N/A | Gradually lower demand from China and elsewhere, combined with rising production capacity, has led to sharply falling commodity prices. In a long-term perspective, this asset class is attractive if inflation rises along with commodity prices. We are taking a wait-and-see approach despite the turnaround potential. |
| **CURRRENCIES** | | | | |
| **CURRENCY PAIRS** | **SEP 8, 2015** | **Q4 2015** | **Q1 2016** | |
| EUR/USD | 1.12 | 1.08 | 1.04 | Short-term upside risk if risk appetite worsens, but this autumn the Fed will hike rates while the ECB moves towards further loosening. |
| EUR/SEK | 9.43 | 9.20 | 9.00 | The Riksbank is fighting against underlying positive drivers and flows. Once Swedish inflation rises, the bank can "let" the krona appreciate. |
| USD/SEK | 8.44 | 8.52 | 8.65 | The dollar will appreciate somewhat against the krona. The risk picture focuses on a scenario with the Fed holding off on rate hikes and Swedish inflation not rising as we and the Riksbank expect. |

*"Weight" shows how we currently view the asset type as part of a portfolio. These weights are changed continuously, based on our tactical market view, and may thus diverge from our long-term strategic view. Tactical expected return is based on the SEB House View as of September 8, 2015. Index/basis for calculation: Global equities – MSCI All Country World Index in local currencies. Emerging markets – MSCI EM TR in local currencies. Swedish equities – SIX Portfolio Return Index in SEK. Government bonds – OMRX T-bonds in SEK. Corporate bonds, investment grade (IG) – IBOXX Investment Grade Index in USD; high yield (HY) – IBOXX High Yield Index in USD. EM debt – JP Morgan Emerging Markets Bond Index in local currencies. Hedge funds – HFRX Global Hedge Fund Index in USD.*

# Market view
## Macro – Dual-track situation in the world economy

*"Dual-track" seems to be the word that best summarises the current world economic situation. Developed market (DM) countries are leaving the crisis behind as emerging market (EM) countries grapple with problems. In the DM sphere the most stable, fastest-growing economy is the United States, but recovery is also continuing in Europe. DM debt is more clearly shifting into public hands, while private sector balance sheets gain strength. Households and thus the service sector are driving growth, while manufacturing and commodities are performing more weakly. Due to EM problems – economic turmoil in China, weak commodity prices and structural imbalances – the biggest global growth risk is now greater weakness in the EM sphere, led by China. Aside from EM worries, we are keeping a close eye on weak inflation tendencies. Although we do not anticipate a deflation scenario, the lack of a pricing component (the ability to raise prices when inflation is low) risks holding down corporate earnings, wages and – in the next stage – growth. Yet our main scenario is that strong households, stimulus measures and low interest rates will suffice to ensure healthy DM growth ahead.*

### US – Rapid, stable growth

After a weaker start to the year, the US economy is again growing at a healthy pace, driven especially by the service sector. Households are an economic engine, among other things reflected in a strong housing market. We expect this year's consumption growth to be the highest since 2006.

Dampening the mood among manufacturers are the stronger dollar and sluggish key export markets, while capital spending is being held back by a squeeze on the energy sector. Looking ahead, the picture will become brighter, which bodes well for the pace of investments and thus growth.

Although we expect stronger growth than consensus forecasts for this year and next, we foresee no economic "boom". Unemployment is already down to equilibrium (where labour shortages and inflationary tendencies often arise), while private consumption is indeed growing but not really at the speed signalled by indicators. This is probably due to more uneven wealth and earnings growth. For the median household, net worth is at the same level as in the early 1990s. Meanwhile, median earnings fell five per cent between 2010 and 2013.

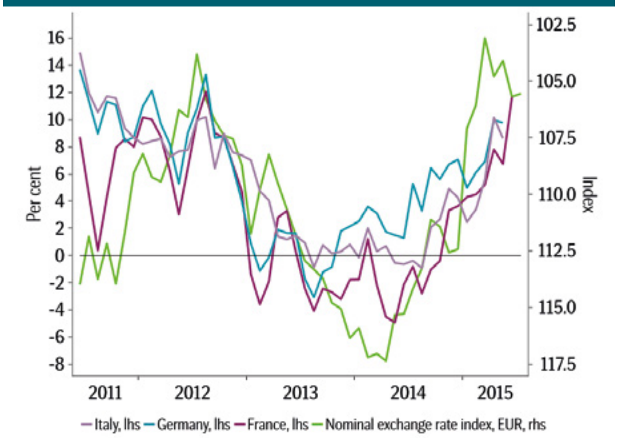
### Europe – Recovery, with obstacles

Since late 2014, growth has gradually speeded up in the euro zone – a trend that we expect to persist – driven by a weaker euro, low oil prices and powerful stimulus measures by the European Central Bank (ECB). Household consumption is also accelerating after several years of crisis and austerity. Growing credit demand also points to a faster increase in business investments. Still, private consumption and capital spending are rising from low levels. Meanwhile unemployment, though falling, remains troublingly high. In terms of momentum the euro zone is among the winners, but its growth still lags behind most other regions of the world.

The euro zone is also grappling with structural issues. Greece's problems should not be underestimated, from a Greek perspective, but we expect minor effects on the rest of Europe since protective "firewalls" are in place. But Greece's problems also highlight the sluggishness of efforts to achieve political and economic integration, which may create concerns about the euro project. Meanwhile the euro zone economy is fragile, with large public sector debt and high unemployment.

The British economy is growing at a healthy pace, driven by stronger productivity. Both household and business indicators also point upward, promising further acceleration. The oil price decline will also have a positive effect.

**WEAK EURO IS HELPING EXPORTS**




Source: ECB and Eurostat

There is a clear association between a weaker euro and stronger exports (to countries outside the euro zone). Looking ahead, exports will also benefit from a slight acceleration in the world economy. The chart shows year-on-year percentage change in exports to non-euro zone countries.

## Asia/China – Persistent growth rate, with India surpassing China

Emerging Asian economies are growing, though the pace of change has stagnated this year. Weaker external demand is slowing exports. Looking ahead, this effect will be countered by US economic acceleration, while domestic demand will remain good. China's deceleration is also being offset by an upswing in India, driven by expansionary policies and lower commodity prices. India is thus taking over China's role as the fastest-growing economy in the region. To retain this position, however, the Narendra Modi government must speed the pace of necessary economic reforms. Overall, regional growth will stabilise at current levels in the next two years, keeping emerging Asia at the top of global growth tables.

China started the second half of 2015 with relatively poor economic momentum. Industrial production, purchasing managers' indices and export/import figures are disappointing, along with the sharp correction in previously overpriced local stock markets. But authorities are responding to the deceleration with fiscal policy actions in the form of infrastructure programmes and monetary policy actions such as interest rate cuts, lower bank reserve requirements and a doubling of aid to local governments.  Along with accelerating growth in other countries, we expect our soft landing scenario to prove correct. Due to uncertainty about China's economic policies, illustrated by its surprising yuan devaluation – and the risk of new disappointments, especially from a continued weak housing market – we view China as the biggest threat to our global growth scenario.

| GDP – YEAR-ON-YEAR PERCENTAGE CHANGE | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|
| United States | 2.4 | 2.4 | 3.1 | 2.6 |
| Japan | -0.1 | 0.8 | 1.3 | 1.0 |
| Germany | 1.6 | 1.9 | 2.3 | 2.0 |
| China | 7.4 | 6.8 | 6.5 | 6.3 |
| United Kingdom | 3.0 | 2.7 | 2.5 | 2.5 |
| Euro zone | 0.8 | 1.6 | 2.1 | 2.0 |
| Nordic countries | 1.6 | 1.8 | 2.1 | 2.1 |
| Baltic countries | 2.6 | 2.2 | 2.7 | 3.4 |
| OECD | 1.9 | 2.2 | 2.6 | 2.4 |
| Emerging markets | 4.7 | 4.1 | 4.7 | 5.0 |
| The world (PPP)* | 3.4 | 3.2 | 3.8 | 3.9 |

* PPP= Purchasing power parities: economies have been adjusted to account for price differences between them.

Source: SEB Economic Research, analysis dated August 2015.

## Japan – Continued uphill struggle, but exports may accelerate

The growth picture in Japan was fairly gloomy in the first half of 2015. Sluggish exports and weak private consumption after last year's tax hike are a clear drag on the economy, but looking ahead the picture will be somewhat brighter. We expect the weaker yen (JPY), combined with a US-led global recovery, to stimulate exports. Accentuating this will be further stimulus by the Bank of Japan this autumn, which is likely to push down the JPY a bit more. Meanwhile private consumption will be buoyed by real income increases due to low inflation.

The acceleration in growth will be modest, however. Consumer confidence is stuck at low levels, hampering the economy, while signs of weakness in China pose a risk to exports. Looking ahead, demographic factors will also set limits on economic growth, while Japan's gigantic sovereign debt will limit manoeuvring room.

## Latin America – Commodities and imbalances cause the engine to sputter

Latin America is still squeezed by weak economies with large deficits and imbalances, coupled with falling commodity prices. The region's biggest economy, Brazil, is no exception. Aside from an increasingly weak economy and fiscal austerity needs, it is suffering from political deadlock due to the corruption scandal surrounding the government-owned oil company Petrobras. As a result of its strained situation, Brazil risks seeing its credit rating downgraded, which would squeeze the economy further. In the long term, the weaker currency is likely to stimulate exports, but problems will probably overshadow opportunities for another while.

## Eastern Europe – Central Europe on track, Russia hurting

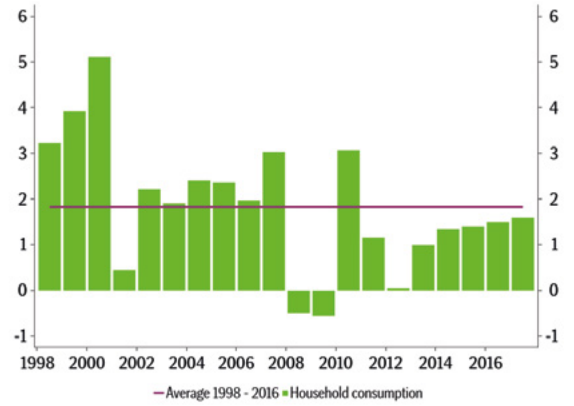
The picture in Eastern (including Central) Europe is obviously mixed. Conflict-embroiled Russia and Ukraine have major economic problems, while the Central European countries continue to perform well and the Baltic countries are somewhere in between.

Russia is in a deep recession. The latest oil price decline will be another setback for an economy already weighed down by a continued drop in private consumption and capital spending as well as ongoing Western sanctions. One reason behind the economic downturn is high inflation, which has led to large real wage declines. In Central Europe, the outlook appears brightest for Poland and the Czech Republic, which are both seeing economic growth close to potential that is driven by strong private consumption due to real wage increases and falling unemployment. From a trade perspective, they are benefiting from their ties to Western Europe, especially Germany, which is more important than their business with Eastern Europe. In the Baltics, growth is also being sustained by an improving situation for households, while proximity to Russia is hampering exports and creating uncertainty.

## Nordic countries – Divergent growth rates

The Nordic economies are continuing to develop in different directions. Norway's growth is being held back by a weaker oil sector, which is affecting large portions of manufacturing. We are thus adjusting our growth forecasts downward, but only marginally thanks to surprisingly strong private consumption. Finland's economy is now emerging from its fifth recession (!) in recent years. Lower oil prices and a weaker euro are providing support, but

**SUBDUED CONSUMPTION DESPITE FINANCIAL STRENGTH**




Source: Statistics Sweden

Despite good finances, Swedish household consumption is growing only slowly. Worries about home prices, the effects of zero interest rates and the sustainability of the social benefit system are making people reluctant to spend. The chart shows year-on-year percentage change in per capita household consumption.

due to lingering structural and economic problems, growth will be weak for another few years. In Denmark, the picture is brighter. Strong private consumption is driving growth, while exports should benefit from improving prospects elsewhere in Europe. The Danish housing market is rebounding towards earlier overheated levels, however, which is a source of concern.

In Sweden the picture is also bright, with the fastest economic growth among the Nordics. But like its neighbours, it is affected by the relatively sluggish global economy. As a result, manufacturing is not really taking off, yet capital spending is growing decently thanks to the construction sector. Households, which have enjoyed good real wage increases in recent years, are indeed consuming more but the increase is well below what the economy would allow. Households are holding on to their wallets and continuing to save, which will only support moderate growth ahead.

## Conclusions from our macro analysis that we take into account in asset management

- Recent worries about economic growth have caused investors to flee risk assets.
- Developed markets are gaining strength while emerging markets grapple with problems.
- The United States is demonstrating stable growth.
- Europe is showing recovery despite structural problems.
- Commodity-producing countries face headwinds, leading to dual-track growth that affects emerging markets, the Nordics and other countries.
- Total global growth is enough to ensure that equities and credit instruments have the potential to perform better than defensive positions such as government bonds and liquid assets.

# Global equities

## Attractive valuations in world stock markets

*The world's stock markets underwent a thorough upheaval in the summer. In many places, this year's share price increases have been wiped out. At first, events in Greece generated worries. Then poorer Chinese growth fuelled market discontent. Despite increased turbulence, share valuations have become more attractive after the downturn and we are keeping a large proportion of our portfolio assets invested in equities. Europe looks appealing, with every indication that economic growth will improve and many companies will benefit from a weaker euro. Asian markets have reached attractive levels after the correction, which creates buying opportunities.*

- A choppy summer has wiped out many of the year's positive returns, with generally falling share prices, but Chinese companies were hardest hit.
- Greece, China and imminent US key interest rate hikes generated worries among investors and led to profit-taking.
- Companies in Europe and Japan continue to deliver upside surprises in their quarterly reports, both in earnings and sales.
- Global equities have become cheaper after the stock market slide and are trading at a price/earnings (P/E) ratio of 15, compared to 17 last spring.
- This market downturn is logical and we are continuing to overweight equities in our portfolios, given our positive view of the economic cycle and continued earnings growth at companies.
- Geographically we are positive towards Europe, where conditions are gradually improving. Asian markets have reached attractive levels after their downturn, but we are avoiding heavily commodity-dependent emerging market (EM) countries.

**After the share price rally** of early 2015 came a really shaky stock market summer. Late in August, the world's financial markets fell sharply and wiped out many of this year's positive returns. Events in Greece led to a gloomy market mood early in the summer, when that country failed to make a timely loan payment to the International Monetary Fund (IMF). Mounting concern about slower economic growth in China and the effects of the US Federal Reserve's likely key interest rate hike worsened the bad mood among investors, persuading them to push the "Sell" button. In the three months to August 31, the MSCI All Country World Index in local currencies lost about 9 per cent, and returns since the beginning of 2015 are thus negative (-5 per cent). This price decline affected stock exchanges worldwide. The Japanese stock market handled the downturn a bit better, while commodity-dependent emerging markets such as Russia and Brazil have shown weakness. The MSCI Emerging Markets index fell 12 per cent during the summer, with Hong Kong (-20 per cent) and Shanghai (-30 per cent) representing the most stunning declines. All calculations are in local currency. A strong stock market rally, combined with signals of lower earnings among Chinese companies, frightened market players.

Due to greater uncertainty about future growth, investors have shifted to defensive sectors with stable earnings. Consumer-related companies and pharmaceuticals are at the top so far this year, while the energy and commodity sectors have struggled. Pharmaceutical firms in South Korea and Japan are the big winners; at the bottom of stock market tables are Indonesian equities in the energy sector.

Encouragingly, second quarter corporate reports confirmed that European companies are moving in the right direction. A high proportion of them showed better earnings than analysts had expected. Sales growth was also surprisingly good in Europe – unlike the US, where half of listed companies reported poorer sales than the market had hoped. Japanese companies also surprised on the upside, both in sales and earnings growth.

**STRONG EARNINGS GROWTH HELPED EUROPE AND JAPAN**


Source: Bloomberg

The chart shows 2015 performance in local currencies for key stock exchanges and regions. Chinese equities on the Shanghai Stock Exchange have been on a roller-coaster ride. After a strong start to the year, mounting concern about the corporate earnings trend led to a price slide starting in mid-June. Overall, emerging market stock exchanges have performed the worst this year while Japan and Europe have done the best, sustained by a stable corporate earnings trend.

### Valuations have become more attractive

In the last issue of *Investment Outlook* (published in June 2015), we wrote in a theme article that valuations of global equities were high in a historical perspective, which might pose a risk to the share prices then prevailing. The market is always more vulnerable to bad news when earnings lead to high valuations, and the summer's stock market slide was caused by falling growth forecasts. After the correction, global equities have become cheaper and are trading at a P/E ratio of 15 (based on 12-month forward earnings estimates), compared to around 17 last spring. Valuations have fallen worldwide, but after the sharp share price downturns in Asia, that region looks attractive, with a P/E ratio of 10. Overall corporate earnings on a global basis are expected to grow by less than 2 per cent this year, but looking ahead to 2016 expected earnings growth is a healthy 11 per cent. India in particular, but also Japan, will show stable earnings this year and next.

### Sources of concern

The turbulent atmosphere that prevailed in financial markets this summer has several causes. The People's Bank of China (PBoC) devalued the yuan in early August, and this greatly increased concern about the state of the Chinese economy and future growth. Investors wondered whether an Asian financial crisis resembling the one we experienced in 1997-98 was beginning. The entire banking system then showed signs of distress. Currencies and stock markets fell sharply. Other sources of concern in financial markets right now are what impact the US Federal Reserve's key interest rate hikes will have and whether US consumers are prepared to open their wallets enough to speed up the momentum of economic growth.

As for American consumers, the trend is moving in the right direction – with increased confidence in their own financial situation thanks to job growth, higher earnings and a more stable housing market. We also believe that financial market players are well aware of the imminent US key interest rate hike, and that this event will thus occur with little drama. It is less likely that the situation in China will worsen very fast. Economic growth has slowed gradually, in a controlled way. Chinese authorities have the monetary and fiscal policy muscle to help sustain the economy but will probably act cautiously to avoid fuelling unsound risk-taking in the private sector. They have intensified their stimulus measures, such as cuts in interest rates and bank reserve requirements, and have continued their infrastructure spending. Positive growth effects and stimulus measures have not yet fully appeared in the statistics. Meanwhile there is plenty of room for continued supportive measures. China is also expected to benefit from accelerating international economic growth.

| COUNTRY/REGION | P/E RATIO, 2016 | EARNINGS GROWTH, 2016 |
|---|---|---|
| United States | 16.1 | 11.0 % |
| Europe | 15.2 | 10.3 % |
| Japan | 14.2 | 19.1 % |
| EM Asia | 10.5 | 10.4 % |
| China | 8.6 | 11.4 % |
| India | 16.7 | 21.2 % |
| Global | 15.4 | 10.8 % |

Source: JP Morgan, August 31, 2015

After their summer downturn, global equities look like a better bargain. Globally, the P/E ratio has fallen from 17 to 15. Earnings are expected to grow by a healthy 11 per cent next year. Asian valuations (especially in China) have fallen to very attractive levels, but uncertainty about earnings forecasts persists. India and Japan will show the best 2016 earnings growth.

### The correction is logical and healthy

Last spring we warned about high valuations, but we were still not entirely prepared for the subsequent stock market drama. Yet the correction has clear causes and is healthy. In our view, it paves the way for new share price upturns. The risk appetite of investors has in fact decreased, and we can probably expect large market movements this autumn. There is greater uncertainty, and we are well aware of the risks connected to a lack of earnings growth, rising interest rates and geopolitical decisions. However, our main scenario is still faster global economic growth and thus higher corporate earnings and share prices ahead. The US economy should accelerate. The euro zone, which was fortunately able to weather the Greek storm this time around, will gradually improve. China will experience a soft landing, since its leaders will take reasonable steps as needed.

Overall, this scenario suggests continued global equity investments in our portfolios. We prefer to invest in Europe, where growth is speeding up and companies are benefiting from a weaker euro. At the macroeconomic level, inflation is low and the European Central Bank is continuing its supportive measures in the euro zone. The contagious effects of the Greek debt crisis have been negligible so far. After price declines, valuations of Asian companies have reached attractive levels and we see good opportunities for bargain-hunting. Investors are probably too negative about the region at present; growth will probably return with support from the rest of the world. However, we will continue to avoid heavily commodity-dependent EM countries like Brazil and Russia. As for the American market, our portfolios are underweighted, but here too companies look cheaper and this should be taken into account.

To summarise, the downturn in global equities is healthy in a long-term perspective. We will remain overweighted in equities, given our positive view of the economic cycle.

# Nordic equities

## History repeating itself, yet differently

*Nordic stock market valuations are higher than the average for the past ten years, but the combination of higher earnings and lower yields and interest rates has raised risk premiums to very attractive levels. However, sharp but short-term share price reactions in connection with discussions on Greece in the early summer and worries about China in the late summer indicate that many investors are uncomfortable with the downward-adjusted return requirements of recent years combined with slow economic growth. The boost in demand that we previously expected to take over as an earnings driver during the second half of the year has not materialised, and when currency effects diminish soon, so will earnings.*

- Higher earnings and lower yields and interest rates mean attractive risk premiums.
- A few companies and currency effects are rescuing earnings.
- Earnings forecasts are being revised downward.
- Continued weak growth, absent a boost in demand.

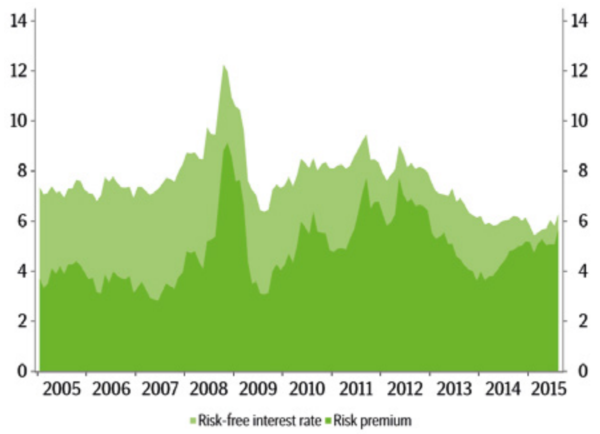
**With a price/earnings (P/E) ratio** of 16 on expected earnings over the next 12 months, the OMX Stockholm exchange is not expensive in a historical perspective, but this year earnings have risen more than share prices. Combined with a sharp fall in yields and interest rates in 2014 and so far in 2015, this has made Swedish equities once again more attractive in a relative perspective than for many years. Risk premiums for Swedish equities, defined as the earnings yield (inverted P/E ratio) on forecast earnings for the next year less the risk-free interest rate, climbed in the late summer to their highest levels since autumn 2012. The fact is that risk premiums have only been higher during the euro crisis of 2011-2012 and following the Lehman Brothers collapse in the autumn of 2008 and spring of 2009.

Of course, because of ultra-low yields and interest rates, investors cannot count on high return levels from any asset class going forward. But provided that earnings grow as we anticipate and the P/E ratio is unchanged, valuations of Swedish equities should rise more than 8 per cent, while dividend yields should increase almost 4 per cent over the next year. It naturally remains to be seen whether this happens, but our assumptions are not aggressive and – compared to the alternatives – equities still look set to be a good alternative.

### Weak earnings growth and low return requirements due to low GDP growth

For the fifth straight year, hopes of substantially better global economic growth in general and a more robust manufacturing sector in particular have been dashed. Because of weak economic growth, the earnings outlook for listed companies is less favourable than in earlier forecasts. Periodically, there were major concerns about the economy this summer too (as in 2014), and once again we needed to revise our earnings forecasts for Nordic listed companies downward. So far this year, we have lowered our net earnings forecast for these companies by 8 percentage points for 2015 and 10 for next year. We now anticipate earnings growth in the Nordic countries of 11 per cent this year and 8 per cent in 2016. However, Sweden has fared better, with about half the level of downward revisions during the year and higher expected growth. Denmark and Finland have instead seen upward revisions for this year and even better earnings growth than Sweden. Norway still has major problems, with falling earnings this year and no noticeable improvement expected in 2016 even though we use oil price forecasts for next year that are more than 15 per cent higher than current levels. Furthermore, most earnings growth in 2015

**LOWER RETURN REQUIREMENT BUT HIGH RISK PREMIUM**




Source: SEB Equity Research

The chart shows the return requirement for Swedish equities broken down into the risk-free interest rate and the risk premium on equities. The return requirement is defined as the earnings yield (inverted P/E ratio) on SEB's aggregate earnings forecast over the next 12 months for companies listed on the Stockholm exchange. The risk premium is defined as the return requirement less the risk-free interest rate. Valuations in the Swedish stock market are higher than the average for the past ten years, but the entire upward revision and a bit more are attributable to the decline in yields and interest rates. The risk premium today is higher than average and has only been higher during the 2011/2012 euro crisis and just after the Lehman Brothers crash.

is an effect of weak Nordic currencies, especially compared to the US dollar and USD-pegged currencies. Earnings revisions would have been even more negative if the euro and the Swedish, Danish and Norwegian currencies had not weakened against the dollar in early 2015.

If we instead divide the market into sectors, the breadth of the downward revisions is clear. Almost every sector has been hit, but the greatest drama by far is in the oil and gas sector and its suppliers. If we add electric power (whose problems are also caused by lower energy prices) to the same group, the picture is even clearer. Earnings forecasts for the oil sector have more than halved, and if the rise in oil prices that we forecast for 2016 does not materialise, further downward revisions will be necessary.

Health care also stands out. It is the only sector where earnings forecasts instead have been revised upwards for both 2015 and 2016. The main explanation for this is the success of the Danish diabetes care company Novo Nordisk. It is also interesting that earnings forecasts for sectors oriented mainly to domestic markets such as banking and finance as well as real estate and construction are essentially unchanged.

On the upside, due to weaker-than-expected GDP growth, monetary policy will remain stimulative in Europe and Asia, and any US rate hikes will be slower and more cautious than has historically been the case. Continued loose monetary policy will benefit the stock market and to a large extent offset somewhat lower earnings growth.

**Stars, currencies and savings rescue earnings**

Earnings growth is being generated by extensive cost savings in many large companies, alongside currency effects. Well-known Swedish examples are Ericsson, Volvo, SKF, Husqvarna and Sandvik, which are all implementing extensive cost-cutting programmes.

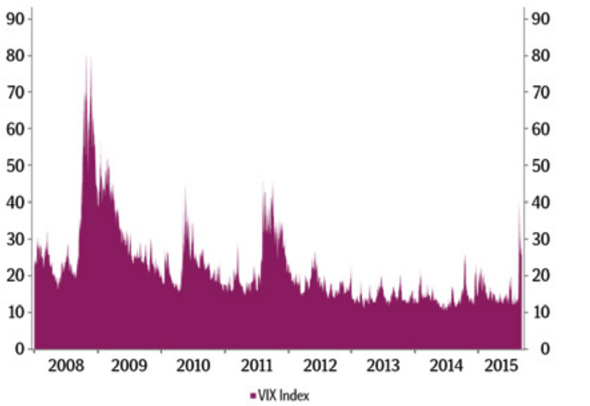
On the plus side, there are also a number of Nordic companies with global operations whose concepts or niches have achieved great international success. Their earnings growth is sizeable enough to affect aggregate figures significantly. Prominent large-cap growth companies such as Assa Abloy, SCA, Hexagon, Hennes & Mauritz (H&M), Kone, Novo Nordisk, Coloplast and Pandora together account for 85 per cent of expected aggregate earnings growth in the Nordic countries in 2011-2016. In 2011, these eight successful companies generated about 9 per cent of total earnings for Nordic listed companies, a proportion that is expected to increase to 16 per cent in 2016.

**China's growth is slowing, but from high levels**

During the summer, investors were almost panicky in their worries about the Chinese growth slowdown and its consequences. GDP growth is gradually decelerating from robust levels over several decades, and the focus of the economy is shifting from infrastructure investments towards private consumption. The trend in China is very important to the global economy, and most major listed Nordic companies have some kind of exposure to the country – for some of them, it is their single most important market. But the slowdown in China is not a new phenomenon, and there are still no clear signs of any dramatic change in pace.

Nordic companies' recent announcements about the Chinese market have been very similar to those issued in conjunction with their reports for the first and second quarter. Companies with exposure to heavy industry and construction noted in their latest quarterly reports that they foresee a gradual deceleration but no collapse, while companies with more consumer-oriented products such as Hennes & Mauritz, SCA and Pandora foresee continued strong demand growth. Furthermore, there are other clear trends. For instance foreign luxury goods, among them exclusive European car brands, are selling more poorly than domestic brands.

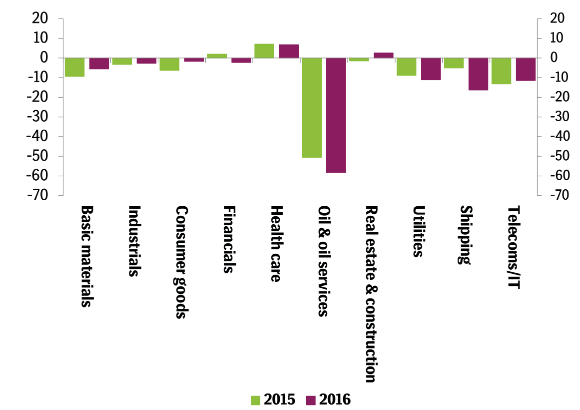
**VIX INDICATES CHINA CONCERNS CAUSED PANIC IN AUGUST**




Source: Bloomberg

The chart shows the VIX index, a good indicator of US investor worries. The index is based on implicit volatility in the options market. During the 1990s as well as over the past six years, it has often been a good strategy to buy shares when investors are extremely worried, but during the period 2000-2008 that strategy generated losses.

**SECTOR DIFFERENCES IN DOWNWARD-REVISED EARNINGS FORECASTS**




Source: SEB Equity Research

The chart shows earnings forecast revisions in percentage terms for Nordic listed companies by sector. Sharp declines in the oil sector stand out, but forecasts for other cyclical industries and the telecom industry have also seen downward revisions this year. Revisions are positive in the health care sector, whereas they are quite modest in the consumer goods, financial and real estate and construction sectors.

### Greek troubles persist

During the summer, Greece – which has been in a more or less constant economic and financial crisis since 2008 – was also the source of considerable worries in financial markets since many people consider the country a major political risk (for instance by providing inspiration to voters in other southern European countries). Economically and financially, the country today is far too small and isolated to have any major impact on the rest of the world.

### US trend reversal adds to concern

In addition to concerns about China and Greece, investors are expecting an imminent interest rate hike by the US Federal Reserve (Fed), marking the end of the country's zero interest-rate policy. Although the Fed's key interest rate will still be extremely low in a historical perspective and the pace of rate hikes going forward is expected to be unusually slow, the US has a history of the first hike being followed by a series of rapid increases, which could have significant repercussions if that pattern – contrary to expectations – is repeated. We do not anticipate any such interest rate trend this time around, nor is that the consensus view, but the risk of such an event nonetheless added to concerns during the summer.

### What do these concerns mean and what should investors do?

Common to these three sources of concern is that they created strong sell-off pressure in the stock market for short periods, even though there was no new information that could be expected to significantly affect the earnings growth of listed companies. During the wave of concern about China, the classic VIX index (which measures the implicit volatility of US options) and the put/call ratio (the percentage of sell options relative to buy options) rose to their highest levels since the Lehman Brothers crash. The only times the VIX has come close to these extreme recent levels were during the 2011/2012 euro crisis and after the September 2001 terrorist attacks.

Without downplaying how extremely negative it would be for the global economy and for the earnings growth of Nordic listed companies if the Chinese economy were in fact to collapse, we believe that the real explanation for the turmoil this summer is something completely different. Although monetary stimulus measures are at an unprecedented level and have been in place for many years, economic growth is weak and corporate earnings growth is not impressive. In our view, this makes many investors nervous since they feel that the situation is fragile.

There are probably also many investors today who are taking a higher risk than they really are comfortable with and historically accustomed to, since that is the only way to generate returns on their capital. It is undoubtedly especially easy for investors who are initially bearing a higher risk than they really desire to be swept off their feet when the market is in turmoil and quickly sell off securities.

What is nice about heightened nervousness in financial markets is that, historically (at least since 2009 as well as during the 1990s), a good strategy has been to buy equities over a 6-12 month period almost every time the VIX surges above 25 (a level the VIX most recently breached on August 21 this year). However, the statistics are not entirely clear; during 2000-2008 a 6-12 month perspective for buying equities rarely worked when worries escalated. One crucial difference between the 1990s and 2000-2008 is valuations, which were far higher after the dotcom (IT) bubble burst. Another difference is that the long-term stock market trend was positive in the 1990s and after 2009 but negative in 2000-2008. We believe the situation today is more like that during the two positive periods than the negative period, which is why it should be right in the short term to follow a contrarian strategy in the face of general market anxiety.

# % Fixed income investments

## Continued low yields, but expect high volatility

*The world's central banks have been and are expected to remain very active. However, what appears to be different as we look ahead is that there will be some tightening and not just monetary stimulus measures. Expectations are that the US Federal Reserve (Fed) and the Bank of England will raise their key interest rates during the autumn, whereas the European Central Bank (ECB), the Bank of Japan and Sweden's Riksbank will continue stimulating their economies. During 2015, bond yields have been volatile. There is reason to believe this volatility will persist. One explanation for this is that liquidity in the bond market has deteriorated, a trend driven by new bond trading regulations for banks and a reduced bond supply as a result of central bank purchases. Yields on government bonds and corporate credits in different segments (high yield and investment grade) have varied considerably during the year.*

- Continued high activity by the world's central banks.
- Low number of bankruptcies due to a stable corporate climate.
- Continued uncertainty in emerging markets.

## Government bonds (excluding emerging markets)

The sharp rise in yields that began last spring peaked during the first week of July, and since then government bond yields have broadly fallen. The main reason for this has been greater uncertainty about global economic growth prospects, but another contributing factor has been uncertainty as to when the Federal Reserve will begin hiking its key interest rate.

### Fed hikes will occur, but when and how fast?

Conditions in the US and Europe are different. The spread between US and German 10-year government bond yields is shown in the adjacent chart. A stable US trend for private consumption and property prices due to a stable labour market has produced growth as well as inflation. So there has been speculation about the timing of the Fed's first interest rate hike. In our view, there will be an initial increase of 25 basis points in September. The Fed will probably wait and see about further measures for a while and then adjust its continuing rate hike cycle depending on how the economy performs.

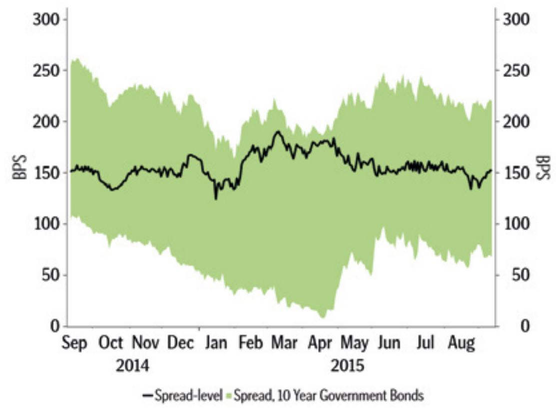
### The ECB will continue its balancing act

Compared to the Federal Reserve, the European Central Bank has a different starting point. The ECB has to take into account the German economy's strong performance, while countries previously grouped under the GIIPS acronym (Greece, Italy, Ireland, Portugal and Spain) need continued stimulus to sustain their economic recovery. This summer's support measures for Greece clearly show how fragmented and diverse economic conditions are in Europe. However, the ECB is likely to continue its asset purchase programme, which is intended to run until September 2016. This suggests an extended period of short-term interest rates near zero and an unchanged key rate.

### Riksbank could set a new record

After two cuts so far this year, Sweden's benchmark repo rate is at a record-low -0.35 per cent. Our forecast is another rate cut to -0.45 per cent. Added to that are the Riksbank's bond purchases, which are planned to continue until the end of 2015 and total SEK 135 billion. The objective of these manoeuvres is to stimulate demand and thereby eliminate deflation tendencies, but also indirectly hold down the value of the krona. Our forecast is that Sweden's key interest rate will remain negative throughout 2016 and only normalise in 2017.

**STABILISATION OF YIELD SPREADS**




Source: Bloomberg

US and German 10-year sovereign yields fell during the first half of 2015. The ECB's bond buying began last spring and explains some of the larger decline for German bonds. Note that the yield spread during the summer months was stable at 1.50 percentage points (=150 BPS, "basis points").

## Corporate bonds – Investment grade and high yield

The year began with narrow credit spreads (the difference between government and corporate bond yields) for both investment grade (IG) and high yield (HY) bonds, which further narrowed last spring. However, the spread widened sharply late in the spring on fears of a Greek exit from the euro zone and the consequences a "Grexit" could have on the European economy. The spread was widest in late June just before an agreement with Greece was reached. During the summer months, credit spreads narrowed, although not to the levels at the start of the year, before once again widening during the turbulence in mid-August.

Because of widening credit spreads, the yield curve also became steeper, which meant that prices fell more for bonds with longer maturities than for shorter-dated bonds (which were affected more by central bank interest rates). Central bank bond purchases provide support for the corporate bond market and have a stabilising effect on credit spreads. Still, there are some clouds on the horizon that may create volatility, as we have seen in recent weeks. Uncertainty about China's economic growth, bankruptcy risks among commodity-producing companies (the oil sector and mining companies), consequences of a US interest rate hike and lingering uncertainty about future developments in Greece are all factors that affect the pricing of corporate bonds.

### Stable bankruptcy risks despite worries

The risk of corporate bankruptcies has generally been unchanged this year despite economic worries. The credit rating agency Moody's notes that there were 45 bankruptcies among the companies they analysed as of July 31, compared to 31 for the same period in 2014. On the downside, the oil and gas sector stands out (25 per cent) as do companies with exposure to metals (20 per cent). Of the 45 bankruptcies occurring in 2015, 31 are North American and only 6 are European. The forecast for the next 12 months is a limited rise in the number of bankruptcies in North America, even though 15 per cent of the market there consists of companies associated with the energy sector. In contrast, a slight decrease in the default rate for European high yield bonds is projected, since the energy sector has a far smaller weight in that market.

## Emerging market bonds (EM debt)

Prospects are still uncertain for emerging market (EM) economies. Political uncertainty in Argentina and Brazil combined with falling commodity prices is squeezing some economies and increasing uncertainty about the payment capacity of these countries. A US interest rate hike may also put some EM countries under further pressure, since those with large current account deficits are more sensitive to rising US interest rates. This will mostly affect Turkey, South Africa and Indonesia and create an extra burden for bond markets in these countries.

During the past few quarters, growth in Asia has stagnated due to China's declining demand. Positive factors include the continued fall in commodity prices and thus an easing of inflationary pressure, while consumption has stabilised. Thailand and Singapore are currently experiencing deflation. This has led to expectations of continued interest rates cuts in the region, especially in India and China. India's key interest rate today is 7.25 per cent and China's is 4.60 per cent. Compared to European and US levels, a great deal remains to be done. But these stimulus measures alone cannot reverse developments; instead structural measures are needed. Vigorous efforts must be made to tackle corruption and a lack of regulatory compliance. The stagnation we now see in some emerging markets could easily deteriorate into recession, especially in Brazil, Argentina and Turkey.

| ASSET TYPE | WEIGHT | TACTICAL EXPECTED YEARLY RETURN | | | RISK | | |
|---|---|---|---|---|---|---|---|
| | | SEK | EUR | USD | SEK | EUR | USD |
| Cash | **1** 2 3 4 5 6 7 | -0.4 % | -0.2 % | 0.2 % | 0.1 % | 0.2 % | 0.7 % |
| Government bonds | 1 **2** 3 4 5 6 7 | -2.6 % | -1.1 % | 0.2 % | 4.2 % | 3.8 % | 3.9 % |
| Investment grade corporate bonds | 1 2 **3** 4 5 6 7 | 1.2 % | 1.5 % | 0.7 % | 2.4 % | 2.4 % | 2.4 % |
| High yield corporate bonds | 1 2 3 **4** 5 6 7 | 3.5 % | 3.8 % | 4.3 % | 3.6 % | 3.6 % | 3.6 % |
| Emerging market debt | 1 2 **3** 4 5 6 7 | 7.1 % | 7.1 % | 6.5 % | 9.5 % | 9.5 % | 9.8 % |

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

Source: SEB

# Alternative investments

## Lower volatility may create investment opportunities

*Sharp movements in global financial markets in recent months have changed the picture and are currently creating both opportunities and difficulties for hedge funds. The year started in a climate that seemed to benefit most hedge fund strategies. Strong stock markets, clear trends and predictable movements for yields, interest rates and currencies were factors contributing to good performance during the spring and early summer for hedge fund managers.*

- Strong stock markets and predictability got the year off to a strong start.
- Trend reversals on a number of fronts in late spring.
- Uncertainty created increased volatility in late summer.

### Hedge funds – This summer's difficulties may lead to opportunities in the autumn

After a stable and relatively uneventful start to the year for hedge funds, the summer months offered quite the opposite. Lengthy negotiations over Greece's debts and participation in the euro project as well as uncertainty about China's economic growth muddied what was previously a clear picture. Nor did hedge fund managers avoid higher volatility, and most strategies generated negative returns during the summer. Provided that global economic data are fairly positive in the near term, there should be a stabilisation in financial markets during the autumn. Lower volatility and a return to more fundamentally driven markets may create good investment opportunities for hedge funds.

**Equity long/short**

Although events during the summer gave equity long/short managers headaches, the strategy delivered good returns until the sharp decline in late August. Following the year's strong start for equities, managers were able to maintain good returns reasonably well through the summer turbulence. Future stability in the stock market with a renewed focus on fundamental factors should benefit this strategy and could create conditions for a rebound.

**Relative value**

Last year, this strategy had serious problems generating returns. Monetary stimulus around the world kept down already low yields, which produced few opportunities to generate returns. However, so far this year, relative value has fared well. Increased volatility in the fixed income market has created ample business opportunities, while this investment philosophy showed resilience during the summer's financial turbulence.

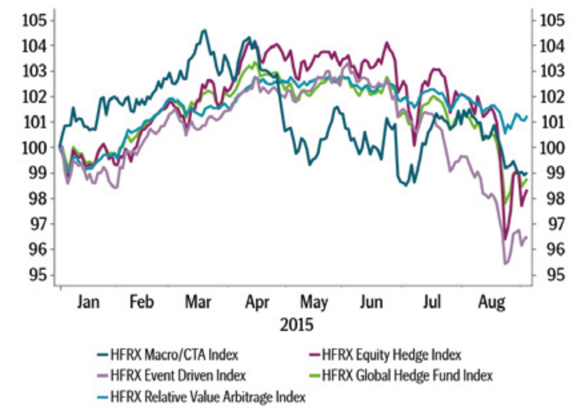
**Event-driven**

Although conditions for merger arbitrage in terms of business volume have been good during the year, this strategy has had problems delivering returns. New regulations on both sides of the Atlantic have created uncertainty and had a negative impact on pricing. Another reason why the strategy has had a difficult year so far is that several high-profile deals have fallen apart. The "special situations" category, which also falls under the scope of event-driven strategies, tends to correlate with equities in times of stress, thus hurting performance during the summer.

**Macro/CTA**

Both macro funds and the more trend-following CTA funds got off to a strong start this year. Robust stock markets, falling interest rates and yields and a stronger dollar were trends that created good potential. A reversal in all these trends in late April was painful for many CTA fund managers who failed to reallocate their portfolios. Macro funds were more successful in manoeuvring through the turbulence. The market correction in late August opened the door for new potential trends if upcoming macro data instil confidence.

**SUMMER TURBULENCE HARD TO NAVIGATE**




Source: Bloomberg

Turbulence during the summer months made life much more complicated for hedge funds. Most strategies were adversely affected, although to a varying extent.

## Commodities – Low oil prices will persist over the next couple of years

Since early June, Brent crude prices have fallen by about one quarter. A continued oversupply combined with worries about China's economic growth are factors behind the sharp decline. There is no indication that the oil market will return to balance either this year or next, so we expect prices to remain low.

At the start of the year, expectations were that the Organisation of the Petroleum Exporting Countries would reduce production to achieve market balance. Contrary to this forecast, OPEC has instead increased production. Furthermore, a nuclear energy agreement with Iran has now been reached, and only US Congressional approval is needed (a vote will be held in mid-September) before sanctions against Iran can start to be lifted. Assuming President Obama overcomes efforts to block approval, toward the end of the year Iran will gradually restore the production levels that prevailed before sanctions were imposed. That means an additional supply of about 1 million barrels/day in 2016 and 2017, with output expected to increase somewhat further after that.

The greatest surprise this year has been the resilience of US shale oil production. Despite dramatic oil price declines, production has been very stable. The number of rigs in operation has fallen 60 per cent since the turn of the year, and investments are down about 40 per cent, but production has not decreased. Instead, production costs have fallen dramatically, the number of drilling days per well has been halved, and volume produced per well has continued to climb. US shale oil can no longer be considered high-cost production. Still, we anticipate somewhat lower production in 2016.

Lower oil prices have led to higher demand. US demand has proved to be very price-elastic, Chinese demand remains stable, and demand in Europe is up for the first time since 2009. In our view, this is still not enough for oil market supply and demand to achieve balance.

Our forecast now is that balance will be reached at the earliest in 2017. Although oil stockpiles in the mainly affluent OECD countries have increased sharply in both 2014 and 2015 and are expected to rise further in 2016 as a result of market imbalance, we believe that this will not lead to a shortage of storage capacity. For instance, the US has capacity for approximately 600 million more barrels. As a consequence of continued oversupply, we expect Brent oil to trade at around USD 50/barrel for the rest of 2015 and the average price next near to be about USD 5 higher. This is a downward revision of about USD 15/barrel from our previous forecast.

**Weaker growth in China is having an impact**

Worries about Chinese economic growth have had a sharp impact on the commodities market. This is logical since the country is by far the world's largest consumer of industrial metals, for instance, and its share of consumption has also been rising. China consumes 11 million tonnes of copper, and global copper consumption is 23 million tonnes; in 2008, it used 5 million tonnes (global consumption then was 18 million tonnes). China now represents more than 50 per cent of global consumption in both aluminium and nickel, and about 50 per cent in copper. China's share of global oil consumption is about 10 per cent.

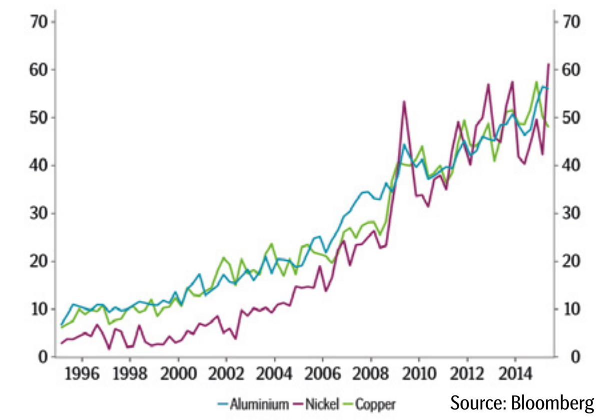
There has been a strong correlation between the US dollar and commodities, with a stronger dollar leading to falling commodity prices. The majority of production takes place in countries other than the US so the price fall over the past year, expressed in local currencies, has been less dramatic. For instance, production of nickel, the most cyclical metal, occurs largely in Russia. China, which accounts for more than 50 per cent of global aluminium consumption, accounts for an even larger share of production but has been a net exporter of the metal for a while, with a weaker Chinese currency thus boosting profitability. We anticipate aluminium prices at around the same level a year from now as well. Nickel prices will also have a hard time climbing until stockpiles fall and production decreases. For copper, our view is that prices will be somewhat lower a year from now.

**OIL PRICES HALVED**


Source: Bloomberg

The chart shows the Brent oil price trend for the past year expressed in USD and SEK. It is clear that the trend last spring and summer was highly volatile. Since currency moves were large, the trend expressed in SEK, for instance, was even more volatile.

**CHINA'S SIZEABLE SHARE OF GLOBAL METAL CONSUMPTION**




Source: Bloomberg

As shown in the chart above, China accounts for over 50 per cent of global consumption of copper, aluminium and nickel. This share has also risen sharply over the past 20 years. Now that the market has begun to worry about Chinese growth, this is quite logically pushing down metal prices.

# Currencies

## Central banks driving FX rates but fundamentals gaining importance

*For a number of years, monetary policy has driven the foreign exchange (FX) market outlook. However, key interest rates have not been decisive; instead, changes in monetary policy have been the dominant factor. Expectations that the Federal Reserve (Fed) and the Bank of England (BoE) will soon raise their key interest rates have lifted the USD and GBP to their highest levels for years, even before these central banks have begun tightening. With persistently low inflationary pressure, a weaker currency is one of the few ways to "create" inflation. As a result, a dependence has developed between the monetary policy outlook and how FX rates move. Tighter monetary policy is rewarded with a stronger currency, also reducing the need to actually tighten.*

- USD – Still strong, but a balanced risk picture.
- EUR – Low inflation, accentuates the need for a weak euro.
- JPY – Attractively valued but will continue to fall.
- GBP – Waiting for the Bank of England.
- CHF – Overvalued against the Swedish krona.
- SEK – Sweden's Riksbank is slowing positive factors.
- NOK – Cheap, but too early to buy.

In August, global stock markets plummeted when worries about Chinese economic growth escalated. The trigger was China's devaluation of the yuan (CNY). The fact that China has devaluated its currency is not so surprising, given its strong real trade-weighted exchange rate trend over the past 5-10 years. We believe that China will allow further depreciation of the currency. Meanwhile our view is that global worries are exaggerated, but the fall in risk appetite shows that economic fundamentals and growth prospects will play a more critical role in the FX market. During this period, the US dollar fell sharply while the Swedish krona strengthened (which is not the normal pattern since the dollar is usually a safe haven in times of turbulence). One partial explanation for the declining USD is that a number of central banks, especially in emerging markets, are selling US government securities to stem the fall of their own currencies. Indeed, the issue of global currency reserves is relevant in an analysis of the USD. China's move toward opening its financial markets and making its currency more convertible will lead not only to the country dropping its USD peg but also to a decline in the dollar's status in reserve portfolios. These factors may have a negative impact on the USD in the years ahead.

Commodity-dominated currencies will remain weak. The euro will continue to fall, although in the short term we expect it to get some support from weak risk appetite. We rank the Swedish krona as one of the stronger currencies, and only further Riksbank actions will counter underlying positive driving forces. Emerging market (EM) currencies have fallen to record lows and will remain vulnerable.

### USD – Still strong, balanced risk picture

We are sticking to our forecast that the Fed will raise its key interest rate in September. Meanwhile we believe that the Fed will proceed very cautiously with further increases. It will thus be difficult for the USD to achieve more long-term support from surprise rate hikes. Whether the USD remains strong will therefore depend on the US economy performing in line with our economic forecasts and on other central banks (the ECB and Bank of Japan) continuing their stimulus packages. The general scenario over the next six months is still that the USD will continue to strengthen, but that there are risks in the short term associated with positioning and risk appetite.

### JPY – Attractively valued, but continued fall

In trade-weighted terms, the Japanese currency has fallen more than 30 per cent since its 2012 peak, and according to our valuation models the JPY is undervalued. Meanwhile expectations are low that Prime Minister Shinzo Abe's three-pronged economic reform programme will achieve its goals (above all, meeting the 2 per cent inflation target over a long period), and we anticipate further stimulative measures from the Bank of Japan (BoJ). If the BoJ succeeds with its inflation targeting, domestic fund managers will also probably continue to reduce the proportion of Japanese fixed income securities in their portfolios in favour of other securities that generate better real returns.

### EUR – Low inflation requires weak euro

The euro zone economy continues to recover, and our growth forecasts are higher than the long-term euro zone trend. The euro is bolstered by a current account surplus, which remains stable at close to 3 per cent of GDP, but at the same time portfolio managers are showing relatively little interest in European equities and bonds compared to 6 to 12 months ago. In trade-weighted terms, the euro is substantially undervalued, but we foresee factors that may contribute to a quick reversal. As long as there are downside inflation risks, the ECB will keep an eye on the euro and perhaps even speed up its quantitative easing (asset purchases). Although the Greek crisis has been temporarily resolved, there is reason to factor in a political risk premium for the euro.

## GBP – Waiting for the Bank of England

After the Fed, the Bank of England (BoE) will be the next central bank to raise its key interest rate. The pound is already overvalued, after hitting historically weak levels, against currencies such as the Swedish krona. However, we believe it is too soon to go against this trend since the BoE will be in a rate hike phase while Sweden's Riksbank is in an easing phase. As a result, the pound will continue to trend like the dollar, with similar risks and opportunities.

## CHF – Overvalued against the krona

Following the Swiss central bank's scrapping of the franc (CHF)'s floor against the euro and the CHF's further 15 per cent appreciation in trade-weighted terms, Switzerland is now headed for a lengthy period of deflation. Yet despite the strength of the currency, exports have not been hit as hard as expected, and the country can clearly handle the stronger currency reasonably well. We are sticking to our forecast that the EUR/CHF rate will gradually rise to 1.10, but given the political situation in the euro zone, new capital inflows to Switzerland cannot be ruled out. Consequently, the currency will continue to trade more strongly than fundamental valuation models indicate – around 1.15-1.20 against the euro. We believe the CHF will fall at a modest pace against the Swedish krona over the next couple of years.

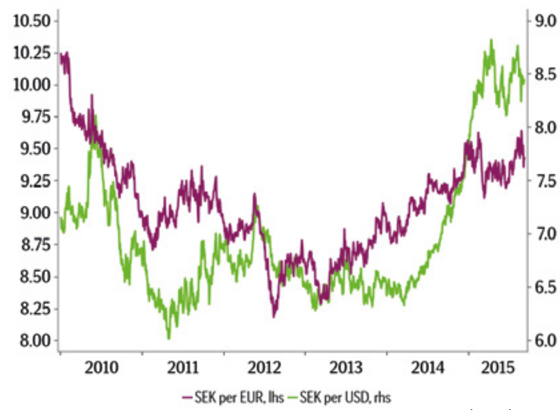
## SEK – Riksbank slowing positive factors

When we rank currencies, the krona is one of the candidates we want to buy. The reason for this is our expectation of strong economic growth in 2015-2016, Sweden's continued large current account surplus and the fact that many market players have sold the krona ensure positive flows since the krona is undervalued. Because of the underlying appreciation pressure, Sweden's Riksbank has been compelled to act very forcefully by cutting its key interest rate to below zero while launching major asset purchase programmes. During the next few months, there is a risk that inflation will fall below the Riksbank forecast, thus forcing the central bank to expand its monetary stimulus one final time. Once inflation reaches 1.5 per cent year-on-year (late 2015), we believe the Riksbank may lower its guard somewhat, which also gives the krona potential to strengthen again.

## NOK – Cheap, but too soon to buy

Norway's economic situation has deteriorated, because oil prices have fallen 50-60 per cent since the summer of 2014. Other sectors besides oil have also slowed. The question is how large the repercussions of a weaker oil sector will be. It will take time to assess these effects, which in the short term will mean a negative risk picture for the Norwegian economy. However, Norway has greater potential than most commodity-producing countries to pursue a stimulative fiscal policy to offset its decline in exports. Inflation is still close to Norges Bank's target, and the central bank is also buying NOK 700 M worth of government securities for transfer to Norway's Government Pension Fund. The currency is moreover at a record low, which may be one reason why Norges Bank will wait and see about further interest rate cuts. On the whole, we expect that growth will be weak and that Norges Bank will be forced to continue its rate cuts. If the autumn budget is more stimulative, this will have positive effects on both growth and flows. We are looking for a situation in which to recommend buying NOK, but we are not quite there yet.

**RIKSBANK IS FACING CHALLENGES**




Source: Bloomberg

Despite the Riksbank's negative repo rate and bond purchases totalling SEK 135 billion, the Swedish krona has not weakened in 2015. A possible delay in the US Federal Reserve's key interest rate hike and a possible increase in the European Central Bank's quantitative easing would pose challenges to the Riksbank as it attempts to weaken an undervalued krona.

| CURRENCY PAIR | FX RATE Now* | Q3 2015 | Q4 2015 | Q1 2016 | CHANGE, % Q4 2015 | Q1 2016 |
|---|---|---|---|---|---|---|
| EUR/USD | 1.12 | 1.10 | 1.08 | 1.04 | -3.2 | -6.8 |
| EUR/SEK | 9.43 | 9.40 | 9.20 | 9.00 | -2.3 | -4.4 |
| EUR/NOK | 9.26 | 9.25 | 9.40 | 9.35 | 1.8 | 1.3 |
| USD/SEK | 8.44 | 8.55 | 8.52 | 8.65 | 1.0 | 2.6 |
| USD/NOK | 8.29 | 8.41 | 8.70 | 8.99 | 5.2 | 8.7 |
| EUR/CHF | 1.09 | 1.09 | 1.09 | 1.10 | -0.2 | 0.7 |
| CHF/SEK | 8.63 | 8.62 | 8.44 | 8.18 | -2.1 | -5.1 |
| EUR/JPY | 134 | 132 | 133 | 130 | -0.9 | -3.0 |
| GBP/USD | 1.54 | 1.53 | 1.54 | 1.51 | 0.2 | -2.1 |
| GBP/SEK | 13.0 | 13.1 | 13.1 | 13.1 | 1.2 | 0.4 |

**The FX forecasts were made by SEB Trading Strategy as of September 8, 2015. Please ask for a copy of our current forecasts.*

# Theme – The Federal Reserve

## What will happen once the Fed hikes its key rate?

*There are many questions surrounding the US Federal Reserve (Fed)'s impending interest rate hikes. Financial market players have wavered regarding the timing of the first rate hike. At first most of them seemed certain that it will occur in September. Later, in light of turbulent markets during August, they changed their forecasts to December or perhaps early next year. We are still forecasting an initial rate hike in September. As for the effects of the Fed's actions – small rate hikes over a long period – these are not entirely easy to foresee, but there are a number of possible consequences.*

- We are sticking to our forecast that the first rate hike will occur in September.
- Market turbulence is a normalisation, not a deceleration.
- The coming rate hikes will maintain a slow profile.
- Because of economic globalisation, a US rate hike now has a broader impact than historically.

**Why?**

Basically the Fed's decision to raise interest rates represents its confirmation that the economy has reached a level where stimuli are no longer necessary. The stimulus process has been going on since 2008 and has consisted of both interest rate cuts and bond purchases (quantitative easing). The first step towards normalising the economy – which in ordinary circumstances generates its own liquidity through the banking system and lending – occurred in the autumn of 2014, when the Fed stopped actively supplying liquidity by purchasing bonds.

**The impact**

An initial key rate hike is often a source of market concern, since it may be seen as a first step towards the tightening that is employed when the economy risks overheating. However, we are not at that point yet. Instead, the imminent rate hike should be viewed as a normalisation of interest rates that is adapted to the current status of the US economy, in terms of macroeconomic data such as the growth rate. Market concern can also be seen as an expression of how the financial system reacts to the fact that the central bank will again be bringing key interest rates into the system.

Today's situation differs from textbook economics, where monetary policy is viewed as being based on a country's domestic situation. We are now living in an increasingly globalised system. Among other things, this is manifested in foreign currency borrowing by many countries, especially in US dollars (USD). This means that to a greater extent than previously, US monetary policy affects other countries – especially emerging market (EM) economies with USD-denominated debts, sometimes combined with weak current account balances and domestic currencies. Expectations of higher US interest rates and a stronger dollar have recently generated market concerns that these countries will find it difficult to service their debts. When China then devalued the yuan (CNY), this was too much for stock markets, which responded with sharp price declines during August.

In the bond market, interest rate hikes imply corresponding general increases in bond yields. Initially, this leads to negative returns as bond prices fall. How much bond yields will rise is highly dependent on inflation expectations. Today, these expectations remain very subdued, which means that the risk of sharp upward yield movements is limited, but we still expect rising bond yields ahead. It is important to note that as long as this movement is reasonable, it poses no threat to equity markets. As for inflation and related expectations, the question is both the extent and type of inflation – in other words, whether it can be expected to help sustain corporate earnings growth or not. The gap between the earnings levels of companies and bond yields is still very much to the advantage of the stock market, and we believe this situation will continue for a long time to come. The calculation should also take into account that the European Central Bank (ECB) will continue to buy bonds (supply liquidity) until autumn 2016. Overall, the central bank-driven global system will remain expansionary even if the US portion is slowly raising its key interest rate.

In corporate bond markets, the Fed rate hike may pose initial problems. History has shown that there is often a slight upturn in risk compensation – a widening of the yield gap (credit spread) against government bonds at the actual time of the rate hike, leading to a decline in prices of corporate bonds. The sharp price movements during August, however, indicate that this time around the market has at least partly discounted an imminent rate hike.

A rate hiking strategy is based on the premise that the rate hike itself signifies economic strength, which is positive for risk assets such as equities. But the timing of a rate hike is often a problem for the market, since volatility often increases and generates some uncertainty. These fluctuations usually subside after a month or so and are followed by a positive long-term trend until interest rates reach such heights that they directly cool off the economy. These levels are probably very far away.

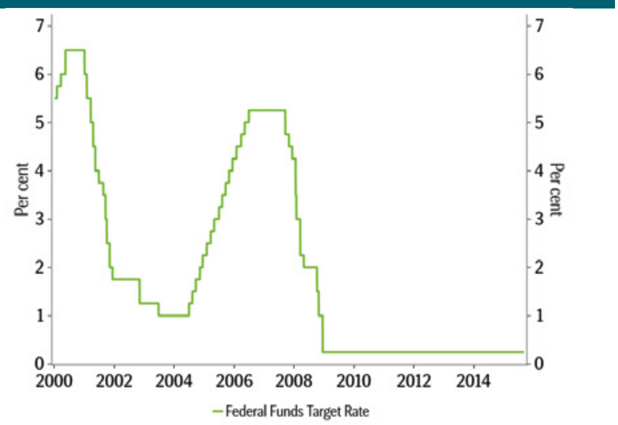
During the current phase – before the initial interest rate hike – the market is largely liquidity-driven, whereas after the interest rate hike, liquidity is expected to be more balanced. This is because tangible investments often absorb capital that would otherwise have gone into financial markets. It also means that to a much greater extent, stock markets will be driven by earnings expectations rather than capital flows.

**New conditions**

Historically, interest rate hikes could also be viewed as the starting point for share price increases in those segments of the stock market that are more sensitive to economic ups and downs (cyclical), since the interest rate hike confirms economic strength. This pattern applies both geographically and to economic sectors. Geographically, it has meant that the US will lose its stock market leadership role and that this role will shift to Europe, Japan and later to various emerging market countries. The explanation for this pattern mainly has to do with the structure of the business sector. The US has a larger proportion of stable companies with low sensitivity to economic cycles, while in Europe, Japan and some emerging market countries, more companies have a greater dependence on economic developments and the investment goods cycle.

Today's market situation presents special conditions, since big emerging market countries like China will not be investing in infrastructure in the same way as before. This has structurally reduced the demand for commodities and thus had consequences for that sector. However, this decline in demand must be distinguished from cyclically driven demand, for example from private construction and productivity-enhancing investments that normally increase when the economy strengthens. In practice, it will probably mean that traditionally cyclical industries will not enjoy the stimulus they usually get and that regions and countries with a high proportion of exports focusing on consumer goods will perform well, since there are many indications that consumption is the main economic driving force in the world today. Falling commodity prices, rising real wages and low willingness to make traditional industrial investments have created a global economy where consumers are in the spotlight and those who sell consumer goods will deliver strong earnings.

**FED FACES ITS FIRST KEY RATE HIKE SINCE 2006**




Source: Macrobond

Our forecast is that the US Federal Reserve will carry out its first key interest rate hike in September, thereby bringing key rates back into the financial system. We also predict that subsequent hikes will occur slowly and in small steps.

# Theme – India

## Attractive potential, major challenges

*India today is the world's fastest growing economy, and the country is expected to become the world's most populous by 2022. The country is poor and renowned for its cumbersome bureaucracy, slow political decision-making processes and corruption, but it has made significant advances since the 1991 crisis. The government of Narendra Modi is pursuing a sweeping reform agenda, which should enable the country to realise – within the foreseeable future – some of the enormous potential for improvement that has long been apparent. India's financial market offers many investment opportunities, with a liquid stock market with a reasonable market capitalisation, long-term government bond yields of 7.8 per cent and a competent central bank. However, stock market performance in the short term will probably be dominated by general investor concerns about emerging markets.*

- Rapid economic growth from a very low level.
- A sweeping reform agenda is aiming at transforming a nightmarish bureaucracy into an economic superpower, but progress will be slow.
- A young, growing population with an increasing share of working-age people will add to the country's good long-term potential for economic growth.
- India's competent central bank has stabilised the currency and consumer prices.
- Listed companies show strong earnings growth and good profitability at historically normal valuations.

**THE FINANCIAL MARKET OFTEN FOCUSES** on the factors that contribute mostly to short-term economic fluctuations, such as credit growth (or contraction). But in a longer perspective, productivity and population growth are the critical factors for economic growth. Whereas Europe, Japan and China face significant challenges in managing an ageing population with an ever-shrinking share of working-age people – and with each person having to support an ever-larger number of pensioners – the situation in India is completely different. India has a young population, with 46 per cent of inhabitants under the age of 25. The population is expected to grow about 1.3 per cent annually, and India is projected to overtake China as the most populous country in the world just seven years from now. Furthermore, the percentage of the population that is of working age is expected to rise, with especially high growth among the urban population.

As for productivity, underdeveloped countries such as India have good potential to benefit from existing technology from leading countries, as long as political and institutional developments move in the right direction. Provided that Prime Minister Modi's government (together with local governments in the country's 29 states and seven union territories, which are at least as important) deliver on the reforms that have been promised and are under way, conditions should be favourable. Urbanisation, which is growing rapidly from a low level, should also contribute significantly to productivity growth going forward, since agriculture still accounts for more than half of all jobs but less than 18 per cent of GDP.

### Reforms critical to growth

In India, pessimists see an unwieldy, bureaucratic and corrupt nightmare whereas optimists note that the economy is actually already the fastest growing in the world today, despite all of these well-known, growth-impeding factors. There is enormous potential for improvement, and growth could presumably be substantial if just a few of the structural reforms are carried out and the lowest hanging fruit is picked.

On repeated occasions over the past year, representatives of India's government – but also central bank governor Raghuram Rajan during his visit to Sweden in June this year – have talked about the sweeping reform programme now under way.

**STRONG RUPEE UNDER CURRENT CENTRAL BANK REGIME**


Source: Bloomberg

The chart shows the performance of the Indian rupee against the Swedish krona and US dollar. After a crisis of confidence in 2013, a new Reserve Bank of India (RBI) management team was appointed, led by Governor Raghuram Rajan. Thanks to a clear focus on consumer price inflation, the central bank has built up investor confidence again and stabilised the currency.

This includes:
• **Ownership of land and processes** to ensure fair compensation for people whose land has been expropriated (which is critical to infrastructure projects and commodity production as well as agricultural investment).

• **Labour laws**. Today business is impaired by rigorous employment protections, while many workers are excluded from the system and essentially have no rights. However, to date there has been no significant progress in this area.

• **Bankruptcy laws** and the ability of banks to settle debts or force financial restructuring of heavily indebted customers. In this area, there are signs of progress on financial restructurings, which have spurred construction projects previously put on hold.

• **Infrastructure**. Massive investments, with China as the role model, are planned, including motorways and railways between numerous major cities.

• **Agriculture**. The country's agriculture is inefficient, but significant progress should be possible with existing technology and limited investment. Distribution of food will also be made far more efficient with the help of better infrastructure, which means less food spoilage. This will also ease inflationary pressure and thus sustain a higher pace of potential economic growth.

• **Taxes**. A simpler, standardised national tax, resembling VAT, which will also reduce administration and bureaucracy. Retroactive taxation has been abolished, but a number of high-profile "old" conflicts are still in the courts, costing the government a great loss of trust among foreign companies.

• **Reprioritising of public expenditures**. The central government budget is largely wasted on subsidies for fuel and energy as well as certain food staples, which produces perverse incentives and widespread corruption. Going forward, these expenditures will be cut, and priority will instead be given to spending for education, infrastructure and health care.

The combination of deregulation in the retail sector (international chains such as H&M and IKEA will now be allowed to operate in India), ongoing and planned infrastructure investments and simpler taxation have potential to revolutionise distribution and logistics in the country, leading to enormous efficiency gains.

As for infrastructure, India still lags far behind China. Infrastructure investments as a percentage of GDP are still much lower than in China, even though they have doubled in ten years, but the trend is in the right direction. The government's ambition is for the motorway network to expand by 11,000 km per year (about 12 per cent of the current total). In 2009-2014 the country's electricity generation capacity doubled. There are more than 900 million mobile phone subscribers in India, and 40 different underground rail projects are being built, procured or planned in different cities.

Infrastructure development in the state of Gujarat, where Prime Minister Modi was once governor, is often highlighted as a key factor behind that state's economic progress while he was in office. Since many major projects have private funding (about 40 per cent of investments are privately run), bankruptcy laws are also crucial to boost infrastructure construction. Banks have historically had difficulty enforcing liens on building contractors in financial straits, so projects with insufficient funding simply come to a standstill instead of being financially restructured. It will take time before banks are formally granted these necessary powers, but some progress is already being made as a result of owners voluntarily transferring equity stakes in projects in exchange for additional funding.

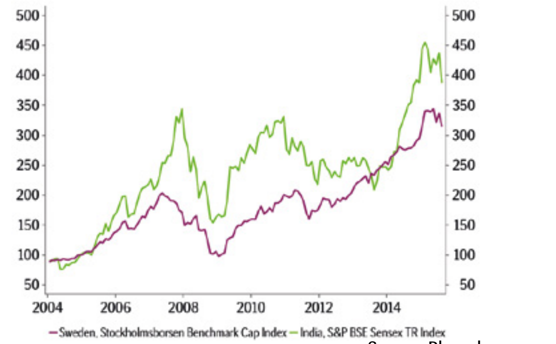
Better infrastructure is also crucial to India becoming a more competitive industrial power. Today the country has a strange combination of a large, inefficient agricultural sector, a successful service export sector including a number

**HIGH YIELD ON 10-YEAR GOVERNMENT BOND**


Source: Bloomberg

The chart shows the yield on 10-year Indian government bonds. With a yield of almost 8 per cent, yields on alternative Indian assets are far higher than in the West, which affects the relative attractiveness of the stock market.

**RETURN, SENSEX (INDIA) VS. OMXS30 (SWEDEN) IN SEK**




Source: Bloomberg

The chart shows total return, including dividends, for Indian equities (Sensex) compared to Swedish equities (OMXS30) since 2005, calculated in SEK.

of leading global IT consulting firms, and a relatively neglected industrial sector. However, Modi's slogan – "Make in India" – indicates that there are political ambitions in this area as well.

Alongside these critical structural reform plans, India has already made great progress in its monetary policy. Since 2013, the Reserve Bank of India (RBI) has clearly highlighted consumer price inflation as the crucial parameter for its key interest rates and has gained considerable credibility in international financial markets for this, which is reflected particularly in the relatively strong rupee.

**Two steps forward and one step back**

Optimists argue that democracy in India favours this growth model, lowering risks of the kind of widespread dissatisfaction among the population that sooner or later could lead to major economic setbacks, as in China, in terms of environmental destruction and land ownership/use. However, because India is a democracy, many decision-making processes are far lengthier than in countries like China. Many people are deeply frustrated by how slowly reforms are proceeding and by the fact that progress is often followed by new setbacks. Many analysts, including SEB, believe the pace of reform thus far under Modi has been disappointing compared to what was expected a year ago.

Still, while many people no doubt consider the pace of reform in India to be slow, business has seen enormous progress since the 1991 crisis, which is often regarded as a turning point for Indian economic policy in the same way as Deng Xiaoping's accession to power in 1978 was in China.

**Political stability and voters with new economic opportunities**

India is an extremely heterogeneous federation of highly divergent states, peoples, religions and linguistic groups. During its first few decades as an independent nation, there were extensive threats to its existence, and discord between different groups often verged on civil war. Today there is a stabilising combination of extensive regional independence and a shared "Indian" identity.

Relatively good political stability makes it easier for politicians and voters to focus on other issues besides security. Largely due to urbanisation and a growing middle class, voters are making demands on politicians to deliver basic services and economic growth to an ever-increasing extent.

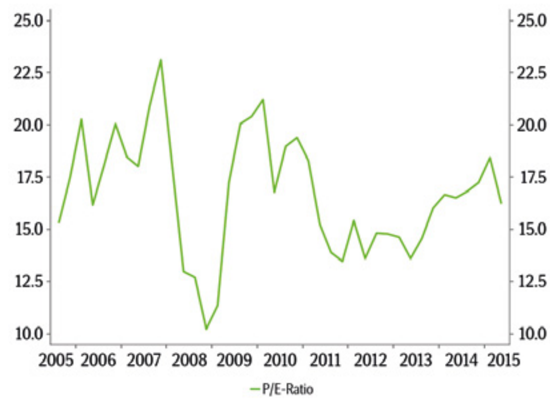
Young people in cities today have far greater opportunities than previous generations in rural areas, who were stuck in the customs and conventions of a caste-based society. According to political scientists, demonstrations against corruption in 2011 and against a horrendous rape in 2013 that attracted worldwide attention marked the reversal of a trend in India's political landscape. The demonstrations were held mostly in cities, and in demonstrating their discontent, the educated urban middle class came across as a unified national group with demands for law and order.

A parallel development that ensures continued pressure on politicians to deliver growth-oriented reforms is competition between the states and their governments. Voters are said to have repeatedly identified and rewarded leaders who provide jobs and prosperity, with Prime Minister Modi being the most obvious but far from the only example.

**Short-term macroeconomic prospects**

Thus far, promised reforms have been delivered at a slower pace than many people had expected a year ago. Yet the International Monetary Fund (IMF) expects India to maintain its position as the world's fastest-growing economy in the near future, and we anticipate somewhat better growth in 2016. The public budget deficit is small enough so that debt as a percentage of GDP is expected to decline, and the trade deficit is manageable. For years, inflation has been somewhat high, but the RBI is successfully addressing the problem and we see room for further interest rate cuts going forward. Last but not least, India – in sharp

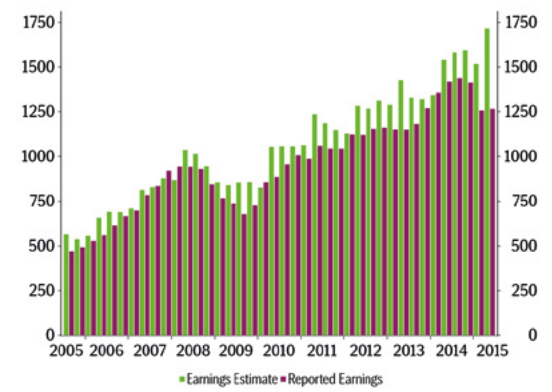
**INDIAN EQUITY VALUATIONS ARE RELATIVELY NORMAL**




Source: Bloomberg

The chart shows the price/earnings ratio for the Indian stock market (Sensex) based on the consensus forecast for the next financial year. Valuations are neither strikingly high nor low in a historical perspective but seem attractive, given growth potential in a longer-term perspective. However, India stands out as expensive relative to stock markets in many other emerging market (EM) countries.

**EARNINGS HAVE TRIPLED IN TEN YEARS**




Source: Bloomberg

The chart shows aggregate earnings for companies included in the Sensex index: both reported earnings for the past year and consensus expectations for the next year. India's thriving IT sector in particular accounts for this excellent performance.

contrast to many developing nations labelled emerging markets over the past decade – has greatly benefited from lower commodity prices. It is the world's fifth largest net importer of crude oil but only the ninth or tenth largest economy and thus one of the world's biggest winners as oil prices have fallen by more than half over the past year.

**Stock market structure**

Like the country in general, the Indian stock market is rich in contrasts. The stock market is well diversified – with many sectors represented, but with an unusually large share of service-exporting companies in information technology for an emerging market. Internationally successful consultancy firms such as Tata Consultancy, Infosys, Wipro and HCL Technologies help make information technology the biggest sector on the stock market alongside banks. According to McKinsey, 45 per cent of all new jobs in Indian cities over the past decade were created in the IT sector. India is also home to a number of internationally successful pharmaceutical companies, such as Sun Pharmaceutical Industries and Dr Reddy's Laboratories, which is also somewhat odd for a country with India's level of development.

Another significant contrast is in the banking sector, which can be divided into two distinct groups: government-controlled and privately held. Government-controlled banks have weak balance sheets and extensive problem loans in their credit portfolios. In contrast, privately owned banks, with just a few exceptions, have strong balance sheets that meet Basel III international leverage requirements by a wide margin, good credit quality ratings and high return-on-equity ratios. Given the government-controlled banks' weak balance sheets, combined with their notoriously poor service, these banks could be expected to continue losing market share to more competitive privately owned banks. Government-controlled banks today account for three quarters of the total assets of Indian banks and are often valued at a significant discount compared to privately owned banks.

India is distinguished from many other emerging markets by the relatively limited presence of commodity companies in its stock market. In the SX40 index of the 40 largest listed companies, basic materials and energy together constitute less than 12 per cent of market capitalisation, with the petrochemicals and petroleum refining group Reliance Industries alone representing more than 5 per cent of market capitalisation. Further down the list of traded companies (ranked by market cap) are a number of names such as ABB India, SKF India and Esab India, which are jointly owned but listed subsidiaries of European manufacturers with the same names.

**Earnings growth and profitability**

Earnings of the 30 largest listed companies in India included in the Sensex index are expected to be more than three times higher this year than ten years ago. This is a far stronger performance than for companies included in equivalent indices in Sweden, Europe and the US, as well as slightly better than for Chinese companies on the Hong Kong stock exchange during the same period. Profitability has dipped somewhat in recent years, but with a return on equity of more than 16 per cent, this is still better than the average for listed companies in Sweden, the US and China and almost twice the European average. Successful IT companies, pharmaceuticals and privately owned banks have contributed substantially to sharp earnings growth for Indian listed companies. In many cases, the same firms also contribute to good average profitability for Indian listed companies.

**Valuations**

The Sensex index is currently trading at a price/earnings (P/E) ratio of 16, which is a normal level historically and somewhat cheaper than – for instance – the Stockholm stock exchange (but a bit higher than the OMXS30 index of Stockholm's top 30 listed companies). Given the long-term growth potential if India succeeds in the reform plans mentioned above, it may be considered genuinely attractive. However, the risk premium that investors today require for Indian equities relative to the country's fixed income alternative, 10-year government bonds with a 7.8 per cent yield, is far lower than for the Stockholm stock market (where 10-year yields are almost ten times lower). India also has high stock market valuations compared to most other emerging markets, and its market has one of the highest valuations in Asia.

The Indian stock market has not escaped the recent slump in share prices but has nonetheless fared relatively well, compared to many other emerging markets. One partial explanation for this is the relatively limited number of commodity companies in the Indian market, but it can also be seen as a sign of investor confidence in the country's economic policy. Unfortunately, general stock market concerns about emerging markets will be the most important factor behind the performance of equities in the short term, regardless of whether long-term reforms are successfully implemented. Still, reforms that promote growth, combined with cheaper shares as a result of general stock market jitters in emerging markets, could create very attractive buying opportunities in a more long-term perspective.

| BASIC DATA | INDIA | US | CHINA |
|---|---|---|---|
| Population, million | 1,267 | 319 | 1,364 |
| Area, 1,000 $m^2$ | 3,287 | 9,832 | 9,563 |
| GDP, USD billion | 2,050 | 18,495 | 10,380 |
| GDP per capita, USD | 1,808 | 56,421 | 8,154 |
| Urban population, % of total | 32 | 81 | 54 |

Source: World Bank, IMF

| INDIA, KEY DATA (MACRO, IMF FORECASTS) | 2015 (F) | 2016 (F) |
|---|---|---|
| GDP growth | 7.5 | 7.5 |
| CPI inflation | 6.1 | 5.7 |
| Public sector, % of GDP | 27 | 27 |
| Current account balance, % of GDP | -1.3 | -1.6 |

Source: IMF

# Theme – China

## More subdued growth, but no drama

*The flow of news about China surged during the summer. The growth of the world's second largest economy is decelerating. This has had consequences for all asset classes, as well as a negative effect on market players' risk-taking propensity. However, slower growth is logical in light of a global economy that is not really gaining momentum and because China wants to end its heavy dependence on the cyclical manufacturing sector in favour of an economy driven more by consumption and services. There are also headwinds from deteriorating demographics, with an ever-ageing population, and excess capacity in industries where central government investments have not been optimally allocated.*

- The real estate market needs time to recover.
- Stock market turmoil, but little impact on the economy.
- Ample stimulus potential if growth decelerates more than expected.
- A growing middle class with service needs will be an increasingly important growth factor.

**During the summer, clear signs** of deceleration included weaker industrial production, falling export figures and lower purchasing managers' index (PMI) levels. However, we believe there will be a soft landing, with GDP growth of 6.8 per cent in 2015. President Xi Jinping set a growth target of 7 per cent for China this year. If this materialised, it would be the slowest pace since 1990.

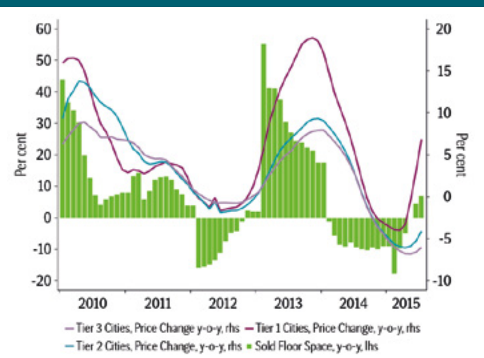
### The real estate market

Another reason why China's growth is decelerating is that the housing market, a key factor for the economy, is weakening. When demand for properties declines, commodity markets are affected. Less steel is used, with the result being that in 2015 China has exported as much steel as Japan, even though China is still by far the world's largest consumer of steel. After large-scale capital spending following the 2008-2009 financial crisis, residential investment as a share of GDP was 10.4 per cent in 2013. When Spain's housing bubble burst in 2006, residential investment represented 12.5 per cent of GDP. There are also numerous examples of countries where the housing bubble burst with investment peaking at 6-9 per cent of GDP. Given China's large population and urbanisation wave, with a larger percentage of people moving to cities, this should lessen the problem somewhat, although housing construction has increased substantially and the market is starting to become saturated. As early as 2012, residential floor space per capita was higher in China than in Spain as well as in Taiwan and South Korea, for example, which is unusual for an emerging market. The time it takes to sell a home is steadily increasing. In smaller cities, that figure is now at a five-year high. However, China's leaders are doing a great deal to stabilise the real estate market. Restrictive rules on home purchases have been eased, and banks have been instructed to approve new mortgages faster. The People's Bank of China (PBoC) has cut its key interest rate in several rounds and also lowered the reserve ratio for banks. This may already have had some effect; during the summer, housing prices rose marginally after 12 straight months of decline.

### Government using many tools

History shows that the Chinese government takes its promised growth levels seriously, and we can expect further interest rate cuts and a lower reserve ratio for banks. The yuan was devalued unexpectedly in August and has weakened about 5 per cent against the dollar, which should benefit Chinese export companies. In our view, there will be further devaluations. Infrastructure investments are likely to be on the agenda again, since there are disadvantaged areas that can be expected to contribute positively to China's growth in the long term as well. Improvements in local transport, electricity grids, water quality and the environment are probable areas for further investment. The government is likely to take the opportunity to make changes in the ownership structure of government-controlled companies. Today the State-Owned Assets Supervision and Administration Commission (SASAC) both owns and regulates companies, which cannot be considered optimal. Many of these companies are inefficient and in some cases corrupt. A change in the ownership structure may entail mergers, with a new ownership structure hopefully producing more optimal corporate governance and more efficient companies in the long term.

**HOME PRICES AND SALES CAUTIOUSLY REBOUNDING**




Source: CEIC, UBS estimate

The chart shows that home prices have turned upwards in recent months, especially in big cities.

As for resolving corruption problems, the current Chinese government has in fact already done a fair amount. An anti-corruption wave in China has been ongoing since 2013, and in July 2014 nine senior civil servants were placed under investigation. In some government-controlled companies, essentially the entire management team has been replaced. In December 2012, more stringent rules against civil servant extravagance were introduced. The aim, naturally, is to show the general public that the government is on their side. It seems to be working, since a majority of the population says it is satisfied with the government's work.

**The stock market, investors and the government**

It has been a turbulent year for China's local stock exchanges, where so-called A-shares are traded. The Shanghai stock exchange started the year strongly, with a 70 per cent upturn between February and June before totally collapsing. At this writing, the market is largely back at where it was at the start of the year.

Earlier this year, many observers said they thought there was a stock market bubble with extreme valuations, but Chinese investors poured into the market as prices continued to rise. The number of new share accounts skyrocketed, as more people wanted to join the stock market rally. Some 40 million such accounts were added in China between June 2014 and May 2015. Many inexperienced stock market speculators took great risks and were rewarded, while some have now lost all their initial capital and sometimes even more. In contrast, many larger investors reduced their shareholdings during the summer. Perhaps many of the more seasoned investors were misled because the government launched numerous measures aimed at stopping the plunge in share prices. Initial public offers (IPOs) have been suspended, short selling has been banned, and government-controlled entities in the financial market have bought shares to support prices and have also persuaded privately owned organisations to do the same. Meanwhile financial institutions have been encouraged to continue lending to investors to buy equities. Interventions by Chinese authorities helped at first, but then share prices fell again. However, the stock market slide is not expected to have an especially great impact on the real economy. Despite the recent downturn, the Shanghai stock exchange has gained more than 30 per cent over the past 12 months. The percentage of Chinese who own shares is still only about 7 per cent, and equities represent a rather small proportion of household wealth, in contrast to real estate, which accounts for about 40 per cent.

**Different stock markets, different prices**

In principle, Chinese investors can choose to invest in equities on the local Shanghai or Shenzhen stock exchanges. Nowadays, foreign investors can trade these A-shares but only after obtaining special permission or through the Hong Kong stock exchange. Since China is still a closed economy constrained by capital controls, it is unusual for small investors there to invest in anything other than A-shares. This behaviour drives up valuations on the domestic stock exchanges. Most foreign equity funds that want to invest in Chinese companies instead buy Chinese equities traded on the Hong Kong stock exchange, so-called H-shares, which are listed in Hong Kong dollars (HKD). Many big companies, with a focus on financials, are listed there. It is common for these companies to trade at a discount compared to the exact same companies traded on China's domestic stock exchanges. One illustration of how valuations took off on the domestic stock exchanges is that A-shares and H-shares were trading at the same price in December 2014; in June 2015, A-shares were trading at a 50 per cent (!) premium in China. Valuations have now fallen significantly for essentially all Chinese equities.

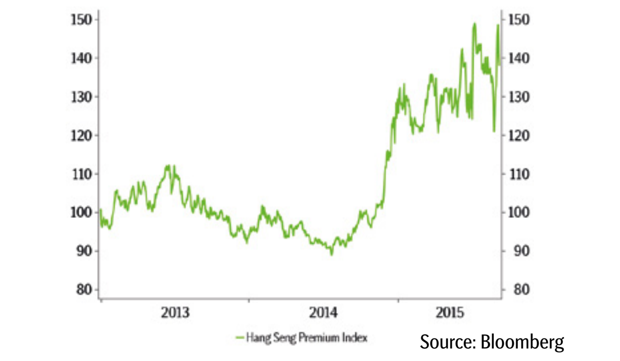
**The future**

It is notoriously difficult to know what is happening in China. Recent market concerns have been exaggerated but not unreasonably so. We believe that China will achieve a soft landing. The housing market needs time to get going again. China is still the most populous nation in the world, with high education levels and hard-working citizens. Many companies there are benefiting from the needs of a growing middle class. That means there are still favourable structural forces in China but they are of a different nature than before. The country also has growth companies that are capturing market share globally and are valued today at more attractive prices. The worries and volatility will continue in the near future, but in a slightly longer perspective the valuations of companies trading in Hong Kong will become attractive.

**RISING LIKE THE SUN, FALLING LIKE A SOUFFLÉ**


The chart shows the performance of the local Shanghai Stock Exchange, which surged during the first half of 2015 before giving up all these gains during the summer months.

**HIGH PREMIUM FOR LOCALLY TRADED A-SHARES**




The chart shows the premium for locally traded A-shares in China compared to the same shares traded on the Hong Kong stock exchange, so-called H-shares.

# Contributors to this issue of *Investment Outlook*

**Fredrik Öberg**
Chief Investment Officer
fredrik.oberg@seb.se

**Esbjörn Lundevall**
Equity Strategist
esbjorn.lundevall@seb.se

**Helene Cronqvist**
Equity Strategist
helene.cronqvist@seb.se

**Carl-Filip Strömbäck**
Economist
carl-filip.stromback@seb.se

**Jonas Evaldsson**
Economist
jonas.evaldsson@seb.se

**Cecilia Kohonen**
Investment Communication Manager
cecilia.kohonen@seb.se

**Pernilla Busch**
Investment Communication Manager
pernilla.busch@seb.se

**Stefan Lukacs**
Economist
stefan.lukacs@seb.se

**Reine Kase**
Portfolio Manager
reine.kase@sebgroup.lu

**Kai Svensson**
Portfolio Manager
kai.svensson@seb.se

**Johan Hagbarth**
Economist
johan.hagbarth@seb.se

**Henrik Larsson**
Economist
henrik.y.larsson@seb.se

**Magnus Sabel**
Portfolio Manager
magnus.sabel@seb.se