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Investment Outlook

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SEB

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Worrisome economic uncertainty

Plunging stock markets, falling government bond yields, rising corporate credit yields and worries about the health of the banking sector are classic patterns when investors' risk appetite fades.

As usual, no single factor is creating this situation, but by far the most important factor is uncertainty about economic growth. As long as the economy chugs along at a reasonably healthy pace and corporate earnings climb, investors can tolerate a rapid oil price slide, a mixed economic picture, uncertainty about China, doubts about the impact of further key interest rate cuts and stimulative asset purchases by central banks, a possible British exit ("Brexit") from the European Union etc. But the opposite is true at times like now, after a period of weaker-than-expected economic performance and quarterly report periods that have continued to generate downward adjustments in forecasts of future corporate earnings.

In all four issues of *Investment Outlook* during 2015, we pointed out the risks posed by the leisurely growth rate and the tendency towards delays in a broad economic upturn. Are the market's worries about slow growth or even a recession exaggerated, or is the market on to something? It becomes apparent that we are in an unusual market situation, for example, when we study American quarterly reports. Car makers are delivering record earnings, while oil company profits have rarely been worse. It may be that we are in a transitional phase towards a slower long-term growth rate and that this, combined with structural forces such as China's shift towards a more consumer- and service-led national economic model, is creating a growth picture that is harder to interpret.

For a long time, oil prices moved up and down between USD 20-40 per barrel (Brent crude). After that they soared, reaching a new balance of around USD 100/barrel a few years ago. Then new North American production came on stream and oil prices plummeted to their current level of around USD 30/barrel. Have oil prices bottomed out, and what will happen to highly commodity-dependent countries such as Brazil that have been slammed by many negative forces simultaneously? If we are entering a period of slow growth and low inflation, what will happen to corporate earnings, and where will capital move in search of returns? These are some of the themes we discuss in this issue of *Investment Outlook*.

We also examine regional growth and inflation prospects, as well as various asset classes and our view of future currency movements, including an in-depth look at the future of the Chinese yuan.

Wishing you enjoyable reading,

FREDRIK ÖBERG
Chief Investment Officer, Private Banking

Market view
Summary

- Greater uncertainty about economic performance.
- The lower the growth rate, the more sensitive the system is to disruptions.
- A year of declining risk appetite has improved valuations.
- Market pricing is based on a low-growth scenario.

The instability of financial markets is related to downward revisions in forecasts of the economic growth rate and corporate earnings trend during the coming year. These revisions are reasonable, since it has been a long time since outcomes exceeded expectations and there have been significant negative deviations. Investors' more cautious view of the future is resulting in a need to reduce risk in their portfolios. This in turn creates volatility, leading to further risk reduction. Such a chain of events risks leading to such consequences as lower business investments and more cautious consumers. Another example is the effect of the large oil price decline. Some oil-exporting countries which used to invest their surpluses in the world's asset markets are now being forced to sell these assets to cover the budget deficits that were created by lower oil revenues.

The picture is not entirely negative, although it may feel that way after the recent very high volatility. Our main scenario is that year-on-year global growth will end up at around 3 per cent and in spite of everything, corporate earnings should manage to climb a bit during 2016. The overall result is a forecast of low earnings increases in the global business sector and dividend yields in the range of 2-4 per cent, depending on the market.

In the fixed income market, expected returns are in the range of -2 per cent to +6 per cent, with government bonds at the bottom and corporate credits at the top. But this presupposes that risk aversion will fade and that the economic picture will stabilise. This is not what the capital market is pricing in at the moment, since yields on high yield corporate bonds have nearly doubled in 12 months.

The very large ups and downs in the market mean that some hedge funds have had a tough time. The best performers have been "trend-following" strategies that have shifted positions in order to generate returns from falling stock markets. On the whole, however, alternative investments are showing clearly lower volatility than the stock market, and are thus serving as stabilisers in a portfolio.

MAIN STRATEGIES IN OUR PORTFOLIO MANAGEMENT

During the past year, we have reduced our risk utilisation in several steps. We began as early as the first quarter of 2015. Growth disappointments, modest earnings delivery, negative oil price effects and especially signs of more and more market stress have made us increasingly cautious. In retrospect, we should have done more and at a faster pace.

At present, the investor community is much more cautious, which is apparent from its level of willingness to take risks. However, we have not chosen to utilise recent market turbulence to boost the equity and corporate credit weightings in our portfolios. The main reasons are that we have still not received signals that the deceleration in growth is ending and the lower the momentum of the economy, the more sensitive it is to reversals.

Nowadays our model portfolios are more neutral towards risk, after several years of overweighting. This implies a slight underweighting of equities and a certain overweighting of fixed income and alternative investments. In our global equity portfolio – driven by a combination of valuation differences and potential growth in profit margins which favours European companies – we have retained an overweighting of Europe at the expense of North America. In fixed income investments, we have lowered our risk by adjusting the percentage of corporate credits downward and increasing the percentage of more cautious holdings. Average maturity is low, since our main scenario is not that yields will fall further from their current levels. In our alternative investment subportfolio, we are avoiding commodities and have stuck to a rather low-risk hedge fund portfolio.

What might make us lower or raise our risk?
What we do not want to see is a continued low growth rate, which poses a risk that financial market stress will increase and amplify the downward spiral. We would then have to make our portfolios even more defensive. Nor do we want to see signs of further problems in the banking sector, since this may have difficult secondary effects.

Before once again increasing our risk, we want to see a stabilisation in economic activity, which is still part of our main scenario a bit further ahead. Other signals that might calm down or possibly boost investors' risk appetite would be rising oil prices and a weaker US dollar. This would help a number of currently weak players connected to the oil sector, which would have a large positive impact on both the stock market and the credit market.

ASSET	WEIGHT	TACTICAL EXPECTATION (12-MONTH)		REASONING
		RETURN	RISK	
EQUITIES				
Global	1 2 3 4 **5** 6 7	5.8%	11.0%	Due to weaker growth, we have adjusted our corporate earnings expectations downward, thus lowering total expected returns to about 6 per cent. Dividend yield has climbed to a bit above 3 per cent. The broad exposure of this asset type provides stability in a highly volatile environment. The big differences between various sectors will persist.
Emerging markets (EM)	1 2 3 **4** 5 6 7	6.3%	14.2%	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 effects of a strong US dollar and rising US interest rates will be minuses for some EM countries, but high growth and net imports of commodities will benefit Asian countries.
Swedish	1 2 3 4 **5** 6 7	9.0%	12.3%	Due to a combination of well-run companies and a balanced allocation between cyclical, defensive and growth companies, at current valuations the Swedish stock market is attractive as long as economic growth remains solid. The weak krona has provided support, but this may change. Further ahead, there are clear risks connected to the real estate market and higher interest rates.
FIXED INCOME				
Government bonds	1 **2** 3 4 5 6 7	-3.9%	4.3%	Due to low government bond yields, portions of the bond market are unattractive. A strengthening of economic conditions or a somewhat higher inflation rate may lead to gradually rising yields during the coming year.
Corporate bonds, investment grade (IG)	1 2 **3** 4 5 6 7	2.8%	3.0%	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	7.8%	3.8%	Yields of around 4-8 per cent stand out in the fixed income world, but as a consequence there is also higher risk than with IG bonds. Low liquidity and exposure to commodities are problems, but this is reflected in pricing. The percentage of bankruptcies is rising, mainly in the oil sector.
Emerging market (EM) debt	1 **2** 3 4 5 6 7	1.5%	10.7%	Yields are high in local currencies, but weak currencies risk undermining returns in terms of the investor's home currency. Risks have generally 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 credits – makes 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 higher production capacity, has led to sharply falling prices. In a long-term perspective, this asset class is attractive if inflation rises along with commodity prices. The oil price decline is primarily a supply-side issue; if producers become more coordinated, conditions will change.

CURRENCIES				
Currency pairs	**Feb 23, 2016**	**Q1 2016**	**Q2 2016**	**Comments**
EUR/USD	1.10	1.08	1.05	The ECB needs (and will help ensure) a weaker euro in order to halt deflationary tendencies in the euro zone.
EUR/SEK	9.35	9.30	9.20	Sweden's strong fundamentals will create a tailwind for the krona, but the Riksbank will continue to do what it can to slow the currency's upward trend.
USD/SEK	8.50	8.61	8.76	The overvalued dollar will remain strong, but we have seen the peak of the USD/SEK exchange rate, and the rate can be expected to remain flat.

"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 February 10, 2016. Currency forecasts are as of February 23, 2016. Index/basis for estimates: 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 (IG and HY), IBOXX Investment Grade Index in USD and 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 – Fragile recovery with downside risks

Recent months have been dominated by worries about the strength of the global economy. These worries have led to sharp price declines in risk assets such as equities, which have fuelled further worries. The biggest sources of concern are an increasingly apparent weakness in industrial activity – especially in the United States – questions about China's economy and currency policy as well as falling oil and other commodity prices, which intensify financial market worries via increased credit risks. We have accordingly lowered our economic growth forecasts for 2016 and 2017 marginally. But although recession risks have increased, there is still potential for a cautious acceleration in growth this year. In both the US and the euro zone, there is underlying strength, mainly driven by robust private consumption due to such factors as improved labour markets. Incoming data about the Chinese economy also indicate that worries about economic growth are exaggerated, while the normal growth-enhancing effects of lower oil and commodity prices will probably come into play during 2016 as oil prices stabilise. Overall, our scenario of cautiously accelerating growth remains in place, but with clear downside risks.

US – Consumers in the driving seat

The American economy continues to operate at two speeds. Sluggishness in the manufacturing sector is increasingly coloured by international developments, with a strong dollar, lower Chinese demand and clearly lower energy prices souring the mood. The heaviest pressure is on energy companies; the oil price slide risks claiming more victims, despite successful productivity-raising efforts. On the other hand, there is good growth and resilience in domestic, service-oriented sectors. This is mainly because households are benefiting from a relatively robust labour market – more people are landing jobs and pay increases can be expected – while their wealth position is improving. We also believe that lower energy (including petrol) expenses will gradually lead to higher consumption. Since private consumption is by far the biggest single element of the US economy, we expect growth to overcome the drag from the manufacturing sector, which is shrinking in relative terms. Economic statistics also support this scenario; in recent decades, the service sector has led manufacturing, not vice versa.

Europe – Robust economy, shaky union

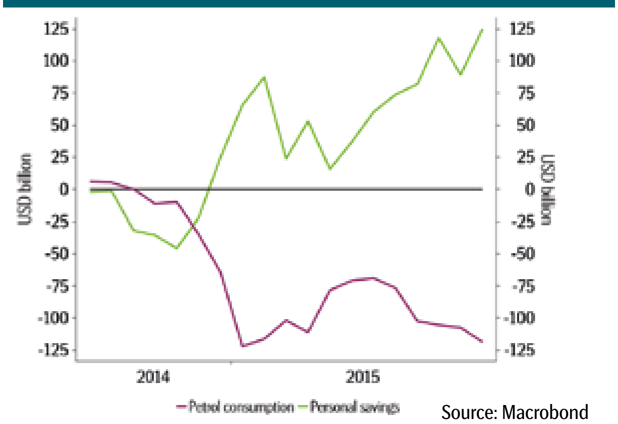
In contrast to the political storm clouds, the euro zone economy continues to stabilise, with slightly increasing growth. Drivers include lower energy prices (the region is a large net importer), while the weaker euro is benefiting exports. Lower energy prices are helping to push down inflation, enabling real household incomes to climb in spite of modest pay hikes. Gradually improving labour markets are also contributing to greater demand. In addition, there are pent-up business investment needs, which are reflected in rising credit demand.

There is also a risk factor here, however, since especially in southern Europe the banking sector is weighed down by a large percentage of bad loans. Other risks are primarily at the political level. The political challenges are apparent, for example given the European Union's inability to manage the refugee crisis and this summer's British referendum on a possible exit from the EU ("Brexit"). Yet the economic impact of Brexit would probably be limited – in the United Kingdom, too, households and the service sector are dominant economic forces that are providing decent growth despite some sluggishness in manufacturing.

Asia/China – Continued growth, with political challenges

We do not believe that the Chinese stock market crash early in 2016 is justified by any major weaknesses in the real

US CONSUMERS IN THE MOOD FOR SAVING



Source: Macrobond

US households are socking away their entire saving from lower petrol prices. Scepticism about how long the current low prices will last, and/or general worries about the economy, are probably behind their unwillingness to consume more, despite their relatively high accumulated savings. This improves the outlook for consumption increases further ahead, when the economy and oil prices stabilise.

economy. The market downturn is due to the inability of the authorities to deal with plunging share prices and their unclear signals about currency policy, which are increasing market worries about new policy mistakes. Of course there are some questions about economic growth, especially related to the manufacturing sector and China's inventory of unsold homes, but because of continued healthy activity in the service sector and an easing of economic policy, we still expect an economic soft landing as growth slowly decelerates.

Elsewhere in Asia some of the smaller countries look stable, with some of the increases in economic growth being driven by the private sector. In India, we expect continued high growth – the country is at the top of the international growth charts. But this increase is being slowed somewhat because the Narendra Modi government has not really succeeded in implementing its ambitious reform programme at the desired pace.

Japan – Uphill struggle for growth

Japanese authorities are continuing their efforts to push up inflation and growth, but with continued underwhelming results. So far, the "Abenomics" reforms launched by Prime Minister Shinzo Abe when he took office three years ago have not had their desired effect. Growth is only slightly positive, and we expect weak public finances to persuade the government to go ahead with its announced consumption tax hike during 2017, which will effectively interrupt the weak upswing in momentum that has characterised the economy this year. Abenomics has been supplemented with further steps to stimulate growth, but we see clear downside risks in the form of weak domestic demand and lack of confidence in economic policies, given Japan's weak public finances.

MISTRUST TOWARDS EMERGING MARKETS

Source: Macrobond

Market worries about emerging market countries are well illustrated by the weakness of their currencies, which have recently declined at an accelerating pace. Structural problems, weaker commodity prices and uncertainty about the effects of the coming Fed interest rate hikes have driven this downturn. Many EM countries are continuing to struggle with these problems. Weaker currencies also fuel inflation, but should brighten export prospects.

Latin America – Commodities dampen the outlook

The region is being squeezed by falling oil and other commodity prices, in many cases combined with structural problems and strong dependence on the US dollar. The situation is worst in Venezuela, but even Latin America's largest economy by far – Brazil – is struggling mightily (see the theme article "When the samba ends..." on page 30). The country is experiencing a long, deep downturn, which has spread through much of the economy – it started with falling export revenue and capital spending, then plunging private consumption, driven by troublingly high inflation and a weak labour market. Although the decline in Brazil's currency has helped its exports a bit, that effect is offset by lower demand from China. Yet we expect the decline in GDP to slow somewhat this year; the picture will brighten further during 2017.

In Mexico, the region's second largest economy, two-speed growth persists – with a depressed oil sector partly offset by exports to the US.

Eastern Europe – Central Europe is resilient to the Russian "flu"

Eastern (including Central) Europe is also showing two-speed growth, although the gap is not between economic sectors as in the West, but instead is geographic. In Central Europe, especially Poland and the Czech Republic, the picture is still relatively positive. Here, too, household demand is an important driving force, as real incomes rise and labour markets improve.

In Russia, the outlook will remain problematic for another while. Aside from structural problems, the conflict with Ukraine and related foreign trade sanctions, the fall in oil prices has slowed economic growth significantly. It is also pushing down the value of the rouble, forcing inflation higher and undermining household purchasing power. We expect continued negative growth this year. A stabilisation in oil prices and an easing of sanctions will lead to weak positive growth next year, but structural problems will limit Russia's potential for a long time to come.

Nordic countries – Strength in Sweden, headwinds in Norway and Finland

The divergent outlook in the Nordic countries is intensifying. Finland is plagued by continued stagnation. Weak public finances and waning competitiveness are hurting its prospects, but we expect a slight acceleration in growth during 2016 and 2017. The Norwegian economy is increasingly weighed down by low oil prices, whose effects are also spreading through the economy, especially to households, but growth will still remain at a decent level thanks to economic stimulus policies and a weak currency. In Denmark, a strong labour market and household sector will enable the country's modest recovery to continue, but due to weak capital spending activity and other factors, we are adjusting our growth forecast a bit lower.

In Sweden, growth has delivered upside surprises. The main reason is higher consumption due to expanded refugee resettlement. Because of a strong fourth quarter, full-year 2015 economic growth ended up at just above 4 per cent. We expect almost equally rapid growth this year, with higher consumption and residential investments as the biggest driving forces, again largely driven by immigration. Major challenges in housing and labour market policy, as well as political uncertainly, pose the biggest risks.

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

- Growth forecasts are continuing to be adjusted downward as recession worries emerge in the public debate.
- We still expect a slight acceleration in economic growth, but downside risks have increased.
- Many advanced Western economies remain split down the middle, with strong household-driven service sectors and weak manufacturing sectors.
- US economic growth is stable, but international weakness will slow its pace.
- The Chinese economy will achieve a soft landing, but there are questions about China's official currency policy and ability to manage stock market turmoil.
- Oil price stabilisation is within reach, but producers remain under economic pressure.
- Downward revisions in estimates of growth and corporate earning are squeezing stock markets...
- ...yet a slight increase in economic momentum and continued low interest rates suggest an eventual rebound for risky asset classes.

GDP – YEAR-ON-YEAR PERCENTAGE CHANGE	2014	2015	2016	2017
United States	2.4	2.4	2.4	2.7
Japan	-0.1	0.6	1.0	0.5
Germany	1.6	1.7	1.9	2.0
China	7.3	6.9	6.5	6.0
United Kingdom	2.9	2.2	2.2	2.4
Euro zone	0.9	1.5	1.9	2.0
Nordic countries	1.6	2.1	2.2	2.1
Sweden	2.3	3.6	3.7	2.8
Baltic countries	2.8	1.9	2.7	3.2
OECD	2.0	2.1	2.2	2.4
Emerging markets	4.7	4.0	4.3	4.7
The world (PPP)*	3.5	3.1	3.4	3.8

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

Source: SEB Research, Nordic Outlook, analysis dated February 2016

Global equities

Waiting for better corporate earnings

Early 2016 was dominated by falling stock markets and major fluctuations in share prices. Industrial activity has not really managed to take off, and worried investors have chosen to reduce their exposure to risk assets. Decent valuations and the broad stock market decline suggest a rebound, but the fly in the ointment is that earnings estimates continue to be adjusted downwards. Overall corporate earnings are expected to grow by 4 per cent this year, but we foresee an acceleration next year. Many of last year's winners have ended up on the losers' list so far during 2016. European small caps and US growth companies have had a tough time, while shares connected to gold prices and certain emerging market countries have performed better. In our portfolios, we prefer exposure to European over US equities.

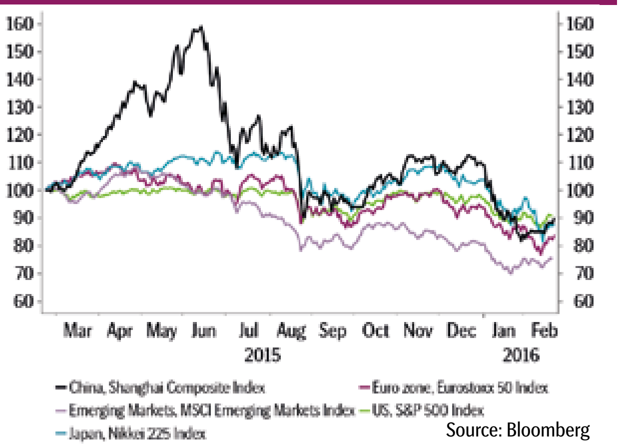
- Falling prices and large fluctuations have characterised stock markets early in 2016. Increased worries about economic trends have frightened the market.
- Equities in Latin America and Russia are showing better performance than the world index – in contrast to last year, when emerging market (EM) shares fell on a broad front.
- Global equities are trading at a price/earnings (P/E) ratio of 14 (based on 12-month forward earnings forecasts) which might be considered attractive if the "E" in the ratio were not as uncertain as today.
- A rebound in corporate earnings and signs of macroeconomic improvement are desirable before we recommend boosting exposure to risk assets.
- Stock markets in advanced countries have good potential, while we foresee risks connected to developing countries. In our portfolios we are overweighting Europe, where we continue to believe that the situation will improve – with higher margins and corporate earnings as a result.

AT PRESENT, THE WORLD'S FINANCIAL MARKETS are characterised by turmoil and major fluctuations. Investors are grappling with questions about the strength of global industrial activity, and the state of the Chinese economy is another source of headaches. Globally, the energy sector weighs heavily in stock market indices, and low oil prices have made a bad market mood worse. This year began with a slump. The world equities index is down about 5 per cent in local currencies. Shares in Latin America and Russia are performing better – in contrast to 2015, when investors broadly rejected EM countries. The very best stock market performers have been shares linked to gold prices. These have risen more than 40 per cent.
The Japanese stock market has plunged after strong growth in 2015. Generally speaking, many of last year's winners are among this year's losers. If this trend continues, one can speculate whether EM and value shares (last year's worst performers) have simply become too cheap, or whether the economy will eventually provide upside surprises. In a scenario where the economy gains strength, value companies with low estimated earnings will be more attractive than growth stocks, which have become expensive after several years of upturns.

Last year's winners at the bottom
At the global sectoral level, last year's favourites are ending up at the bottom. Financials, consumer discretionary goods, information technology and health care have been the biggest losers, while consumer staples, telecoms and utilities have performed better. Owning financial shares in Japan and Europe is a downer so far in 2016, while South African mining companies are "worth their weight in gold", with a return of no less than 25 per cent.

Global equities are trading at a P/E ratio of 14 (12-month forward earnings forecasts) which might be regarded as attractive if only the "E" in the ratio (earnings) were not as uncertain as today. The US stock market is trading at slightly higher valuations than the world index, and Europe is in line with the average. Japanese companies are attractively valued after falling to a P/E ratio of 13, and we forecast earnings growth in 2016 as well as 2017. Globally, overall corporate earnings are continuing to be revised downward. They are expected to grow by 4 per cent in 2016, but consensus forecasts see an acceleration next year to earnings growth of nearly 10 per cent. The Latin American countries, led by Brazil, are at the top in terms of improved corporate earnings after several years of negative figures. At the bottom is

TOUGH FOR EMERGING MARKETS



Source: Bloomberg

The ups and downs of Chinese shares over the past year have been dramatic. There is mounting concern about China's economy and growth. The stock market downturn since December has been broad and has adversely affected all markets. EM shares have performed a little better since New Year but remain at low levels.

Russia, where the well-being of companies is strongly correlated to oil prices. The Indian stock market is valued at a high P/E ratio of 16 but is expected to show high earnings growth.

Earnings are being adjusted downward

Decent valuations and a broad stock market downturn suggest that a rebound is coming. If we end up in a situation of upside growth surprises and rising commodity prices, the upturn may be vigorous for many depressed industrial and commodity-related shares. The fly in the ointment – the factor that is making investors hesitant – is that analysts' earnings estimates are continuously being revised lower, and newly published corporate reports have confirmed this negative trend. Both US and Japanese companies reported poorer-than-expected profits, while earnings prospects looked somewhat brighter in Europe. Downward adjustments in the energy and commodity sectors pulled down averages during 2015, and this trend is continuing. Companies in consumer-related sectors appear likely to improve their earnings the most in 2016.

Uncertainty about the strength of the global recovery has increased. Statistics are not showing quite the improvement that had been hoped for. GDP forecasts are being lowered, and the growth scenario is being postponed. We believe that a recession is unlikely, but downward earnings adjustments and large market fluctuations are making us cautious in the short term. There are also concerns that weak industrial activity will spread to the strong consumer and service sectors. Nor can we rule out new crises in the EM sphere in a situation of continued low commodity prices, higher debt and a strong US dollar.

The world is divergent

At present, the world economy is divergent. Some areas are close to or already in a recession, while others are showing solid growth. Generally speaking, commodity-dependent countries – especially emerging markets – are having difficulties, while advanced economies with large service sectors are managing better. Commodity-dependent markets are hard-pressed, while the outlook is good for global consumption. The classic manufacturing sector is struggling with overcapacity and falling prices, while the service sector is chugging along. In China, the service sector recently surpassed the manufacturing sector in size. In the future, services will continue to expand and create new investment opportunities. In a world where it is increasingly difficult to find returns, it is important to be selective and to "cherry-pick" among potential investments.

Many signs point to stabilisation

On the plus side, stock market declines have resulted in lower valuations and more normalised pricing of equities. Investors have already reduced risk and taken more cautious positions, which also suggests a stabilisation. Low commodity prices are supporting consumption and pushing down inflation, benefiting advanced countries. Still-supportive central banks actions are boosting risk appetite – modestly, of course, but enough to speed up growth in 2016.

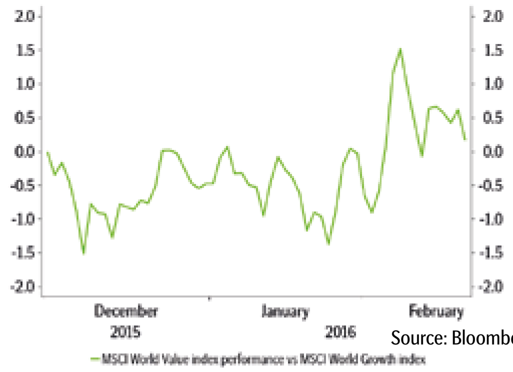
Upwardly revised corporate earnings and signs of macroeconomic improvement would be desirable before we are prepared to increase exposure to risk assets. Stock markets in advanced counties have good potential, while the risks are higher in EM countries. But Asian economies should be helped by stronger consumption in the West. Emerging market countries have historically been lumped together, but today range from countries with strong democratic tailwinds and reform ambitions to countries struggling with deeply rooted corruption and headwinds from falling commodity prices. In other words, selectivity will be very important.

Merchandise trade is shrinking

Western consumers are increasingly demanding digital products and services instead of physical products, contributing to a decrease in the quantity of goods shipments. This has an impact on the volume of world trade and makes it hard for the transport sector to survive on trade between Europe and Asia. Yet there is continued growth potential for physical products thanks to demand from the growing middle class especially in India and China.

In our portfolios, we are overweighting Europe, where conditions are improving and leading to higher profit margins and corporate earnings as a consequence. Valuations of European companies are also more attractive than those in the US. The profit margins of US companies have reached historical highs and can hardly improve much more. After their downturn, Japanese equities also look attractive, with stable earnings growth expected during the next two years.

HAVE VALUE SHARES BEGUN TO REBOUND?



Source: Bloomberg

Value shares have underperformed growth shares for several years. Since December, however, the trend has been a bit better for value shares. In a scenario where economic performance improves, value companies with low earnings estimates are more attractive than growth shares, which have also become expensive after several years of price gains.

COUNTRY/ REGION	P/E RATIO 2016 (F)	EARNINGS GROWTH, 2016 (F)	EARNINGS GROWTH, 2017 (F)
Globally	14.5	4.1	10.0
United States	15.4	3.6	13.6
Europe	14.2	3.3	12.6
Japan	13.0	12.8	10.7
India	15.9	16.3	16.5
China	8.9	7.8	13.5

Source: JPMorgan /IBES /MSCI

Overall corporate earnings are expected to grow by 4 per cent in 2016, but an acceleration is being forecast for next year. Japanese companies are attractively valued and will enjoy stable earnings growth in both 2016 and 2017. The Indian stock market is valued at a high level but will show strong earnings growth ahead.

Nordic equities

Worse earnings trend, lower valuations

Stock markets across the world, including the Nordic countries, began 2016 with steep price declines. At its lowest in mid-February, the Nasdaq OMX Stockholm exchange (OMXS30) index was down 13.7 per cent from the turn of the year. Initially, the same concerns about the economy that we saw in late 2015 drove down prices. A worse economic trend than expected was also reflected in year-end financial reports for 2015, which generally showed a poorer year-end than expected, especially for companies in cyclical industries. This led to significant downward adjustments in earnings forecasts. However, other causes for concern then took over as the main drivers of this downturn, above all anxiety over stress in the credit market and concerns about European banks.

- Weak profit trend, and we expect negative earnings growth in the Nordic countries this year.
- Valuations are more attractive, but not dramatically so.
- Bargains to be had in growing quality companies.
- The lack of alternatives is providing support, with expansionary monetary policy and ultra-low interest rates still the stock market's trump cards.

The energy sector's problems in the credit market have spread and are now affecting the risk premium in a number of other sectors, not least the financial sector. Moreover, due to regulatory decisions about how troubled European banks will be able to strengthen their balance sheets with public funds, financially weak institutions have had a harder time funding their activities. The risk premium for unsecured bonds issued by weaker European financial institutions (the annual cost of hedging via credit default swap derivatives, or CDSs) doubled between year-end and mid-February to 8.7 percentage points.

The stock market slump was also linked to a dramatic rise in volatility, especially intraday and between individual securities from similar companies trading on the same day. We consider the occasionally extreme volatility to be a further sign of significant uncertainty among investors.

However, recently volatility has again decreased, the stock market and credit market have rebounded from their lows, and concerns about the economy have eased considerably.

CHANGE IN LOCAL CURRENCIES DURING THE PAST THREE MONTHS

	Share prices	Earnings outlook	P/E ratio contraction/ expansion
OMX (Sweden)	-10 %	-4.5 %	-6 %
KFX (Denmark)	-7 %	-3.0 %	-4 %
OBX (Norway)	-11 %	-14 %	3 %
HEX (Finland)	-9 %	0.5 %	-10 %

Source: Bloomberg

The table shows the performance in local currencies of the four main Nordic stock exchanges over the past three months, as well as the change in consensus earnings estimates for the coming 12 months over the same period. The difference between these is the change in the forward P/E ratio for the same stock exchange. The decline during the most recent three-month period was broad but is explained in many cases by a deteriorating earnings outlook. Nonetheless, there are clear exceptions, where the decline is purely a multiple contraction, while the earnings forecast is stable. The same pattern is apparent at both the sector and company level.

Bargains in stable growth generators

Starting in mid-January, there was a clear change in the nature of the stock market downturn; concerns about the economy eased, and equities in cyclical companies have outperformed the market in general. Looking at the Nordic stock exchanges, we also see big differences in what caused the decline in prices over the past three months. All of the Nordic stock exchanges reported a price decline of 7-11 per cent over three months in local currencies. The decline on the Oslo stock exchange can be explained by the downward revision in earnings forecasts, while the stock market decline in Finland can instead be fully explained by lower valuations, with earnings forecasts unchanged. The downturn on the Swedish and Danish stock exchanges is due in almost equal parts to a weaker earnings outlook and lower valuations.

The same pattern is seen at both the sector and company level. In many cases, downward-revised earnings estimates can largely explain share price declines, but shares in some cyclical companies with large downward revisions in their earnings forecasts have already rebounded sharply from their lows and price/earnings (P/E) ratios have increased substantially. Meanwhile many of the Nordic companies with the most dependable earnings growth have seen sharp share price declines despite strong fourth quarter 2015 reports and signals of continued growth in 2016 as well as negligible downward forecast revisions (or even positive ones). In an environment of weak economic growth and ultra-low interest rates, we believe a significant premium is justified for companies that can be expected to demonstrate earnings growth going forward, even if the general economic trend remains somewhat sluggish.

This year's slump in share prices has not yet produced any obvious bargains in the market as a whole, but for more selective investors, we believe many individual equities have become really attractive, at least for those who can accept continued high volatility in the short term. We find a number of the most dependable earnings growth companies on the list of large-cap Nordic companies with this year's worst performing equities, with price declines of 5-20 per cent – declines that are explained in full by lower valuation multiples. There are probably some bargains to be had here.

Weak earnings trend

General economic indicators in late 2015 and early 2016 have largely delivered downside surprises, although a stabilisation and recovery have been discernible more recently. Corporate earnings reports for the fourth quarter 2015 were also worse than expected. On average, Swedish companies delivered a downside surprise of 4 per cent, while the overall average for the Nordic countries was minus 8 per cent (adjusted for one company that constituted an extremely negative deviation). Moreover, many companies have warned of somewhat worse performance in 2016 than analysts had expected, and we have seen sharp downward revisions in earnings estimates.

Earnings estimates have been revised lower for all sectors except real estate & construction and health care so far this year. To date, earnings estimates for 2016 have been revised 8 per cent lower; over the past six months the downward revision has been 16 per cent.

Today we expect negative earnings growth in 2016 of 2 per cent for the Nordic countries as a whole. For Swedish companies, we still expect earnings growth of 3 per cent this year. However, as recently as the turn of the year we had anticipated a 10 per cent increase from a somewhat higher base in 2015 than what turned out to be the actual figure (2015 earnings were about 1 per cent lower than we expected before year-end reports were published). Without the help of the weak Swedish krona, earnings growth would probably have been non-existent for companies on the Swedish stock exchange as well.

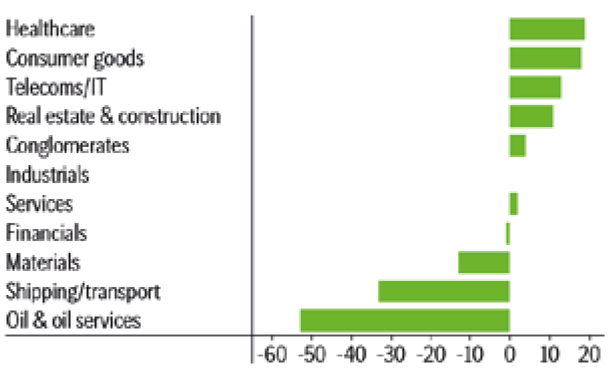
Dual-track market situation persists

Looking at the earnings outlook for 2016 by sector, a dual-track market situation has clearly emerged. Sectors that suffer from low energy and commodity prices and weakness in global manufacturing, as well as companies that lose out from China's ongoing economic transformation process, will show sharply negative earnings growth this year. Meanwhile the consumer goods, health care and construction & real estate sectors are seeing healthy earnings growth. The telecom sector is also expected to recover after a weak performance in 2015.

The trends noted above are strong and show no sign of slowing – quite the opposite. The sectors that have had the worst earnings growth and which we expect to have the biggest negative changes in 2016 are also the ones for which we have been forced to lower earnings growth estimates recently (both over the past two months and the past six months), and this applies to earnings estimates for 2015 as well as 2016 and 2017.

However, the need for downward revisions has been much less if we look at the sectors for which we already had high expectations; for construction & real estate, estimates have even been revised upwards. That is, the downward-revised estimates over the past six months are mostly explained by the fact that the companies with the worst earnings trends provided even greater downside surprises, whereas those for which we expected an improved performance from the beginning have delivered essentially as

DUAL-TRACK MARKET SITUATION PERSISTS



Source: SEB Equity Research

The chart shows the expected percentage change in 2016 earnings by sector for Nordic listed companies. The market situation is still dual-track, with big earnings declines expected in some cyclical sectors, while consumer goods companies, health care and real estate & construction show continued growth.

SHRINKING NORDIC EARNINGS THIS YEAR

Source: SEB Equity Research

The chart shows aggregate earnings growth for Nordic listed companies in per cent. After two years of growth in 2014 and 2015, earnings are once again expected to shrink this year. In Sweden, we still anticipate earnings growth of 3 per cent, but that is entirely attributable to positive foreign exchange effects; in terms of euros, Swedish companies are expected to report unchanged earnings this year.

planned. The sole exception is the telecom/IT sector, which had big downward revisions but is showing positive earnings estimates for 2016.

Lower valuations, but no bargain prices

Unfortunately, downward-revised earnings estimates make it difficult to see any general "bargain prices" in the stock market after the recent slump. The P/E ratio for earnings estimates over the next 12 months is marginally lower today than the 2014 and 2015 average in Sweden. For the Nordic countries as a whole, it is on a par with 2014 but lower than in 2015. For sluggish multiples such as price-to-book value (P/BV), the situation is somewhat more favourable. Since the second half of 2013, the Stockholm exchange has only had lower share valuations than today for brief periods, but they are still about 30 per cent above their 2011 lows.

Scarcity of growth

Of the 132 large-cap companies (with a market capitalisation exceeding 1 billion euros) in the Nordic countries that we follow, only 60 are expected to deliver earnings growth in 2015, 2016 and 2017. Overall earnings growth will be negative this year, and five of the eleven sectors (including two of the largest) are expected to deliver shrinking profits in 2016. Thus there is still a scarcity of companies that can show stable earnings growth, and we believe that this quality should be especially appreciated in an environment like today's, with ultra-low interest rates and expansionary monetary policies.

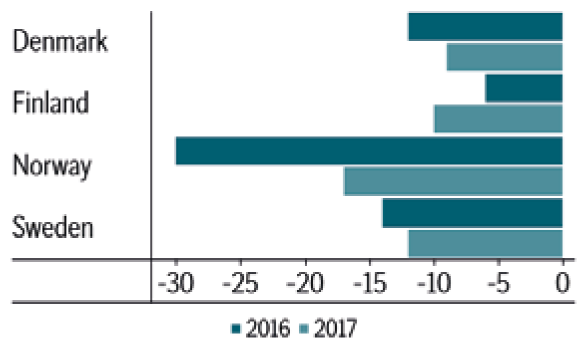
Fast-growing niche companies and companies with stable earnings growth will also be adversely affected from time to time by general financial market turmoil. However, such situations should be of relatively short duration thanks to continued support from monetary policy.

VALUATIONS HAVE FALLEN, BUT NOT AS MUCH AS SHARE PRICES

Source: Bloomberg

The chart shows the P/E ratio for consensus earnings estimates over the coming 12-month period on the Stockholm exchange. Valuations have fallen from last year's peak levels, but not dramatically. Lower earnings estimates explain a large part of this decline.

SHARPLY LOWER EARNINGS ESTIMATES IN ALL NORDICS



Source: SEB Equity Research

The chart shows downward revisions of aggregate earnings estimates for 2016 and 2017 over the past six months for Nordic listed companies by country. We have seen continuous downward revisions for five years, but in the past six months the pace of such revisions has been remarkably fast.

% Fixed income

Continued heavy central bank activity

Long-term government bond yields have fallen early in 2016. The main reason is concern that global economic growth will lose momentum and in turn dampen inflation prospects. This uncertainty has also caused investors to shift their focus from equities and high yield corporate bonds to safer government bonds, which is driving up demand for these bonds and pushing down yields. As a result, at this writing France, the Netherlands, Switzerland, Sweden, Germany and Japan all have negative yields on government bonds with maturities up to five years. Central banks around the world face new challenges as financial markets await stimulus measures; meanwhile the effectiveness of such measures appears to be diminishing at an ever faster pace.

- More of the same is expected from the central banks.
- High yield bonds are dominated by concerns about falling energy prices.
- Continued difficulties in emerging markets

Government bonds (excluding emerging markets)

Sweden's Riksbank is sticking to the same chosen path and has further cut its key interest rate to -0.50 per cent. Meanwhile, the central bank's government bond purchases continue, and its holdings will reach one third of total outstanding sovereign bonds by the end of June. This is equivalent to 200 billion Swedish kronor or 6 per cent of GDP. These measures are aimed at meeting the Riksbank's inflation target of 2 per cent (± 1 percentage point). To further underline the seriousness of the current situation, the Riksbank has not ruled out currency interventions. The aim of selling Swedish kronor would be to weaken the currency, which in turn would be expected to increase demand for Swedish goods and raise the price of imported goods. Demand could be considered the Riksbank's biggest headache for the moment, since supply is being met via an extremely accommodative monetary policy. Perhaps demand will need some help from fiscal policy in countries that have budgetary leeway for this.

As for the euro zone, we believe the European Central Bank (ECB) will lower its deposit rate by 0.1 percentage point to -0.40 per cent no later than at its March 10 meeting. The deposit rate is the interest rate that banks receive for depositing surplus liquidity overnight at the central bank. The ECB will probably also choose to expand its interventions in the capital market by increasing the monthly pace of its asset purchases by 15 billion to 75 billion euros. Since a key interest rate below zero can lead to major imbalances in the economy, it is likely that some technical restrictions may be lifted. At present, the ECB may not buy government bonds with negative interest rates, which excludes the purchase of bonds with maturities of less than five years in a number of countries.

The ECB's problems are similar to the Riksbank's; inflation refuses to climb, despite a positive economic growth trend.

In December the US Federal Reserve (Fed) implemented its first key interest rate hike in ten years, and there is uncertainty as to whether there will be more increases in the near term or whether the central bank will decide to hold off until the end of 2016. The Fed's decision will have a major impact on the situation in many countries, since they have issued bonds with coupons denominated in USD. In our view, the Fed sees a big risk in acting too soon and too forcefully, so we expect them to hold off until the second half of the year before implementing the next rate hike.

Corporate bonds – Investment grade and high yield

High yield bonds were hit hard by the slump in oil and base metal prices, with rising yields and falling bond prices as a result. The Norwegian market for high yield bonds is dominated by oil-related companies and has recently seen a significant reduction in the number of new bond issues;

INCREASED UNCERTAINTY HAS WIDENED CREDIT SPREADS

Source: Bloomberg

Falling oil prices and concerns about the European banking sector have widened credit spreads in both the US and Europe.

meanwhile some bonds issued by well-known companies have been priced at levels that signal debt restructuring. It is highly likely that the number of companies that need to restructure their debt or suspend payments will increase in 2016.

In the US, the energy sector accounts for about 15-20 per cent of the total high yield bond market, and it is mostly new market participants in unconventional oil extraction that must resort to the bond market to shore up their funding. As a result, the US credit index has fallen and is now on a par with 2008 levels. The chart on the left page illustrates how the problems in the US market are related to the energy sector. Europe is traditionally less exposed to energy and is instead weighted more towards bonds issued by banks and other financial services companies.

The European high yield bond market has avoided much of the turbulence connected to falling oil prices, whereas uncertainty in the banking sector has instead created selling pressure on subordinated loans lately. These bonds are issued by financial institutions to strengthen their capital base. There is a growing risk that companies' financing costs will increase as a result of rising yields and wider credit spreads between government and high yield bonds. In itself, this may lead to a downward spiral by fuelling further credit concerns, which may lead to an increase in the number of bankruptcies. So far, this uncertainty has been limited to the US oil and energy sector along with euro zone financial institutions, and at present we see little risk that it will spread to other parts of the economy.

Emerging markets – Growing concern about the future

A strong dollar, rising US interest rates and falling commodity prices are not favourable factors for emerging markets. Meanwhile strained government finances in many emerging markets limit the potential for fiscal stimulus in these economies.

These factors, together with uncertain economic prospects in most emerging market countries, represent a growing risk and put pressure on their government bond markets. The corporate bond market is indirectly affected as a result of lower economic activity, with rising credit risk as a result. The fact that some EM corporate bonds are issued in USD also makes the situation more difficult. Future US interest rate hikes will probably lead to a stronger dollar and higher borrowing costs; meanwhile government revenues from commodity markets have declined significantly.

As for China, we believe economic growth will slow in an orderly fashion over the next two years, from 7 per cent today to 6 per cent in 2017, which should affect nearby exporting countries such as Japan and South Korea.

Another region with problems is South America, including Brazil, the continent's leading economy. Falling oil and iron ore prices have led to negative growth and high inflation. Meanwhile the country is suffering from high inflation. In January, it was more than 10 per cent year-on-year. Prospects look brighter for emerging markets that benefit from ECB monetary stimulus. Eastern (including Central) Europe – led by the Baltic countries, Poland and the Czech Republic – have close trade ties with Germany and Scandinavia, which are relatively strong given the current economic trend.

India experienced strong growth in 2015, and there is reason to believe that this growth will also continue in 2016 and 2017. Unlike South America and Russia, India benefits from low oil prices, which is reflected in both higher growth and rising yields and interest rates.

ASSET TYPE	WEIGHT	TACTICAL EXPECTED YEARLY RETURN			RISK		
		SEK	EUR	USD	SEK	EUR	USD
Cash	**1** 2 3 4 5 6 7	-0.5%	-0.5%	0.5%	0.2%	0.2%	0.2%
Government bonds	1 **2** 3 4 5 6 7	-3.9%	-1.4%	-2.0%	4.3%	4.5%	4.5%
Investment grade (IG) corporate bonds	1 2 **3** 4 5 6 7	2.8%	2.9%	1.6%	3.0%	2.9%	2.9%
High yield (HY) corporate bonds	1 2 3 **4** 5 6 7	7.8%	7.9%	8.4%	3.8%	4.1%	4.1%
Emerging market debt	1 **2** 3 4 5 6 7	1.5%	4.5%	-1.5%	10.7%	10.7%	10.7%

Source: SEB

"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.

Alternative investments

Central banks dictating conditions

It has become increasingly clear that central bank actions have fundamentally affected financial markets. This has led to side effects that are difficult for most hedge funds to manage. Yet regardless of whether the various stimulus measures implemented around the world bear fruit or not, we should be nearing the end of the era of dependence on central banks that we are now experiencing. If continued stimulus measures prove fruitless in terms of increased economic growth and inflation, measures other than monetary policy actions will be forced onto the agenda.

After oil prices plummeted about 65 per cent from late June 2014 to late 2015, our view was that most of the drama was behind us. That turned out to be wrong. Oil prices have continued to fall and market worries have increased.

- Central banks are setting the agenda.
- High volatility is putting the fundamental pricing mechanism out of action.
- Non-existent yields in a difficult market are temporarily challenging absolute return strategies.

Hedge funds – New conditions in a changing world

Many hedge fund managers may well have heaved a sigh of relief when the New Year was rung in. Last year turned out to be far more challenging for hedge funds than was apparent at the start of 2015. Many funds failed to deliver positive returns, with some generating substantial negative returns. Yet managers had barely caught their breath in January when new challenges appeared.

The 2016 financial market year got off to a dramatic start, with steep declines in both share prices and government bond yields, hyperactive central banks with different agendas, falling commodity prices and a pricing mechanism that seems to be driven more by fear than by fundamental factors. As a result, many hedge funds began the year in negative territory. However, at this writing, the markets have rebounded somewhat, and a stabilisation – perhaps temporary – can be discerned. A stabilisation is really all that is needed for hedge funds to have an opportunity to turn around their negative performance. A stabilisation means some kind of predictability and potential to generate returns from fundamental mispricings, which are usually abundant after periods of turbulence.

Equity long/short

Despite high volatility, this hedge fund strategy fared rather well in the face of the recent uncertainty. As a group, those who employ this strategy have reduced their risk level and have thereby managed to decrease its negative effects. In times when fundamental factors take a back seat to a categorical reduction in risk, equity long/short tends to experience difficulties. However, following the declines early this year, there are great opportunities to find sources of return in the form of non-fundamental mispricings.

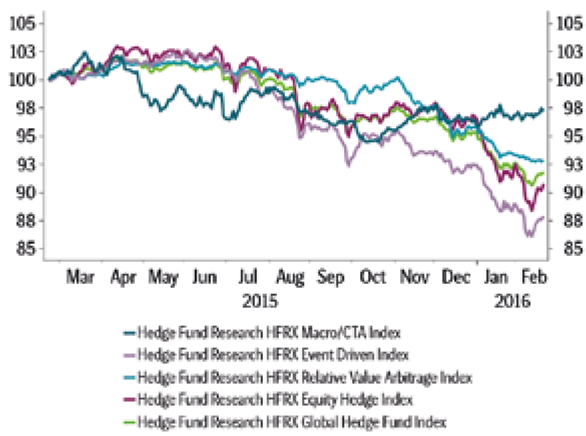
Credit long/short

Falling oil prices have created increased concerns in credit markets over the past year – especially in the US, where the energy sector weighs heavily in the overall index. Expectations of a higher bankruptcy rate combined with reduced liquidity in the bond market have caused credit spreads to widen. With more stable oil prices and significant price differentials in the credit markets, there is scope for positive returns if uncertainty eases.

Event-driven

The subcategory of this hedge fund strategy that focuses on mergers/arbitrage coped well with uncertainty early in the year. The level of new corporate deals announced fell somewhat in January, but this was offset by the fact that many deals announced earlier are expected to be completed during the first part of 2016. In

MACRO/CTA – THE BRIGHTEST STAR



Source: Bloomberg

In 2016 most strategies got off to a difficult start – except for Macro/CTA, which began the year strongly after a difficult 2015.

contrast, the other main subcategory – special situations – was severely punished for its stock market correlation. Good prospects for corporate events in the short term combined with a more stable stock market should make this an attractive strategy during the first half of the year.

Macro/CTA

Overall, trend-following strategies started the year off with long positions in government bonds and USD plus short positions in equities and commodities, a combination that made these strategies a winner early in the year. At present, positions are largely the same, and future performance will depend on the abruptness of changes in the different sources of return. Macro funds also got off to a strong start in 2016, and there are apparently bright prospects of a directional shift in monetary policies around the world.

Commodities – new energy for oil prices

After oil prices had plummeted about 65 per cent from late June 2014 to late 2015, the majority of market analysts agreed that most of the drama was behind us. That turned out to be wrong, since oil prices fell to almost USD 26 per barrel in mid-February, equivalent to a decline of almost 30 per cent from the turn of the year. Concerns about the global economy combined with increased worries about developments in China weighed down prices.

Early in the year, at times the oil price slide felt relentless. Lower demand than previously forecast, higher supply than expected, record global oil stockpiles, greater concern about China, a stronger US dollar and increased worries about the global economy were too challenging an environment for oil prices despite earlier sharp declines. Prices plunged further when sanctions against Iran were lifted in January. Iran's explicit ambition was to return to pre-sanction production levels as soon as possible. In that case, an additional one million barrels per day would potentially be supplied to an oil market already out of balance due to oversupply. Iran has not yet boosted its production to any significant extent, but the risk and Iran's ambition remain.

The co-variation between oil prices and share prices has been very strong this year; almost without exception, days of rising oil prices also saw share prices rallying. This is partly due to changes in risk appetite, but selling of assets by the sovereign wealth funds of oil-producing countries have also been a contributing factor. After a period of high volatility, at this writing oil prices seem to have stabilised somewhat, at least temporarily.

The market has long hoped that the Organisation of the Petroleum Exporting Countries (OPEC) will cut production to achieve market balance. That has not been the case; instead, production has been at record levels and there are no current signals pointing to cuts. In our view, supply will remain at a stable or slightly decreasing level. Although we foresee some growth in global demand, this means that the market will not achieve a balance until the end of next year at the earliest. We expect oil prices to bottom out during the first half of 2016, then rise somewhat and head towards USD 50 per barrel in 2017. Should OPEC change its policy and cut production, it may change this scenario.

For industrial metals, too, 2015 was one of weakest years in history. Nickel fared worst, falling more than 40 per cent, while aluminium was among the winners despite a drop of almost 20 per cent. Since China is easily the world's largest consumer of metals, concerns about its economy have had strong repercussions. Industrial metal markets must get back into balance and stockpiles must be reduced before we can expect any major price increases. Production facilities have closed, but so far that has not been enough. There are still concerns about low demand, especially from China, due to the country's ambition to transform its economy into one driven more by consumption than investment. But signals of weakening industrial activity are also coming from the US. In our view, increased demand will not resolve the imbalances. We do not expect any major price increases before we see further production cuts.

SIGNIFICANT OIL PRICE DECLINE SINCE SUMMER 2014

Source: Bloomberg

After oversupply led to an oil price decline of about 40 per cent in 2014, prices fell by another one third in 2015 and most market participants believed the fall was at an end. The start of 2016 was even more dramatic, if that is possible, with a decline – at its peak – of another one third.

COPPER PRICES IN USD AND LOCAL CURRENCY

Source: Bloomberg

Like most metals, copper has seen a sharp price decline in recent years. The metal is priced in USD, and many large-scale producers are located in countries whose currencies have weakened, so the price decline is less dramatic expressed in local currency. The chart above shows recent copper prices in USD and Chilean pesos.

Currencies

Key central banks losing importance

The foreign exchange (FX) market is still caught in the grip of the central banks. By expanding their monetary stimulus measures, many central banks are hoping to push up imported inflation due to weaker exchange rates. But market participants are starting to doubt whether this is a sustainable strategy, and the FX market is no longer responding to lower interest rates in the same way. Strong fundamentals, valuations and central bank actions will be critical factors, and both the Swedish krona and US dollar are still strong candidates for appreciation.

- USD – Rising commodity prices and gentler central bank policy will strengthen the USD only marginally.
- EUR – The euro is crucial to the ECB and "must" be weakened.
- GBP – A rapid decline after exaggerated concerns about Brexit.
- JPY – The surge in the JPY in recent months is not justified, given weak fundamentals.
- CHF – Expensive valuations are paving the way for a weaker franc.
- SEK – The Riksbank can prevent the inevitable appreciation of the krona only temporarily.
- NOK – Undervalued, but we do not yet see a buying opportunity.

We have written many times about the great importance of central banks to the FX market. In an environment of sustained low global inflation and idle resources, the currencies of most countries are critical elements in the efforts of central banks to achieve their inflation targets. With one exception (the US), recent inflation patterns can also be linked to FX developments. Countries with a weaker exchange rate seem to have managed to boost their inflation rate. The eagerness of Sweden's Riksbank to weaken the krona and thereby bring back inflation to a level close to its target reflects this perspective.

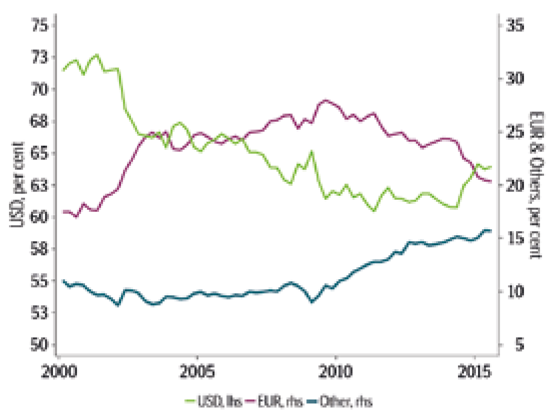
But recent financial market turbulence also highlights some worrisome trends for central banks. The markets no longer react as strongly to the stimulus measures that are implemented. Monetary policy moves have thus not led to weaker currencies – quite the opposite. There are a number of reasons for this development; the most obvious one is that market participants have, to some extent, stopped believing that central banks will actually succeed in achieving their inflation targets via negative interest rates.

Financial market turbulence early this year caused the FX market to focus on China's currency policy (see the extra theme text on China's currency) and on global commodity markets. We believe this focus will gradually fade during the spring. China has the reserves it needs to defend its exchange rate when large capital outflows batter the country (something that is happening right now). Concerns about weaker risk appetite should gradually ease, and as the US shows that recession worries are unwarranted, the FX market should once again focus on underlying fundamentals and differences in future monetary policies. Valuations are another important issue; the currencies of many emerging market (EM) economies are attractively priced after major declines in 2014-2015.

USD – marginally stronger

The US dollar has appreciated by 20 per cent since the summer of 2014. Falling commodity prices, a change in China's FX policy, pressure on oil-producing countries and pay-downs of USD-denominated borrowings will help strengthen the dollar. All these factors pose monetary policy challenges to the Federal Reserve (Fed). Sell-offs by currency reserve managers and oil producers (mostly dollars) will not be enough to offset the effects of monetary policy, which over time will still slightly benefit the USD. However, in our view, the Fed will wait until September 2016 before implementing a further interest rate hike and will deliver two 0.25 percentage point rate hikes in 2016. Over the next few months, the USD will thus be driven by other factors besides Fed policy. As we gradually distance

RESERVE MANAGERS CONTINUE TO REDUCE EURO EXPOSURE



Source: IMF, Currency Composition of Official Exchange Reserves (COFER)

As a result of constant crises and a high political risk premium, global managers of national currency reserves have reduced their exposure to euros in favour of exposure to US dollars and other currencies.

ourselves from expectations of an American recession, this will have a slightly positive effect on the USD. During the spring, we expect the USD/SEK exchange rate to remain in the 8.20-8.80 range. A little further ahead, the USD/SEK rate should move past 8.20 toward 7.50-8.00. Only a global recession or a collapse in the Swedish housing market would bring the USD/SEK rate to 9.00-9.50.

EUR – "must" be weakened

With the EUR/USD exchange rate at 1.10, most analysts think the euro is undervalued. Indeed, a reasonable value in our view is just below 1.20. In an environment of idle resources, low or falling commodity prices and low core inflation, the ECB needs a weaker euro to boost the inflation rate. We believe that the ECB will accomplish this. The political risks in Europe are the greatest long-term challenge to the euro. If the United Kingdom votes to leave the European Union, the euro will also be hurt.

JPY – rapid appreciation unjustified

After a lengthy period of great weakness, the yen has regained lost ground with a vengeance over the past two months. Several factors are contributing to this: 1) the currency is substantially undervalued, 2) low and falling commodity prices are helping improve Japan's current account balance, 3) negative positions in speculative accounts were closed out when risk appetite weakened early in the year. In 2016, we believe these factors will not provide such a positive contribution anymore. The Bank of Japan has also lowered its key interest rate to below zero, and we expect two further 0.1 percentage point cuts to -0.30 per cent in 2016.

GBP – Brexit worries exaggerated

The EU Council summit on February 18-19 agreed to some concessions demanded by the UK, but the market reaction was very negative after Boris Johnson (the Mayor of London) came out in favour of leaving the EU. For the pound, the risk of a British exit (Brexit) will trump all other macroeconomic arguments until the June 23 referendum. The Bank of England will not change its monetary policy before the issue is decided. We predict that the country will remain in the EU.

CHF – high valuation

Since the currency surged last year, inflation has fallen below zero, and the Swiss National Bank (SNB) is clearly focused on limiting the franc's upside. If it appreciates, the SNB will intervene. Our long-term equilibrium estimate for the CHF/SEK exchange rate is around 7.50, and we still expect a cautious CHF depreciation against most currencies. The risk of CHF appreciation is mainly attributable to political risks in Europe, for instance, if the UK leaves the EU and we have a major downturn in risk sentiment. This scenario is not improbable, but it is not our main scenario.

SEK – stronger krona inevitable

Despite a very strong macroeconomic start to the year in Sweden, the krona has weakened against the euro. The underlying factor, of course, is the highly expansionary monetary policy pursued by the Riksbank, aimed at keeping the krona weak. But every time the Riksbank adds stimulus, the FX market responds by purchasing kronor. This should be seen as a sign that a majority of Swedish FX market participants are underweighted in kronor, while the market is increasingly questioning whether the Riksbank can continue its existing policy or not. If the krona appreciates by another 3 per cent from today's levels, that is, moves toward 9.00-9.10 against the euro, there is an imminent risk that the Swedish central bank will nonetheless intervene to ensure that its inflation-boosting prospects are not derailed. Our forecast is that the EUR/SEK rate will remain in the 9.20-9.50 range over the next couple of months but that the strong economy and valuations point to krona appreciation during the second half of 2016.

NOK – undervalued after oil price decline

The Norwegian krone has been severely tested over the past few years. From a peak of 1.31 against the Swedish krona after the financial crisis, the NOK/SEK rate fell to 0.95 in early 2016. This depreciation obviously reflects the fall in oil prices and the very weak growth the Norwegian economy is expected to show over the next few quarters. But Norway also has resources to support its domestic economy through its sovereign oil fund, which today has some NOK 7 trillion in assets under management. Due to the risk of recession, the country's fiscal policy may contribute further stimulus (withdrawals from the oil fund), which would ironically enhance the prospects of NOK flows via Norges Bank's own NOK purchases. The NOK is also significantly undervalued, and we furthermore believe that oil prices will stabilise or rise slightly in 2016.

CURRENCY PAIR	EXCHANGE RATE				CHANGE %	
	Now*	Q1 2016	Q2 2016	Q3 2016	Q1 2016	Q2 2016
EUR/USD	1.10	1.08	1.05	1.04	*-1.8*	*-4.6*
EUR/SEK	9.35	9.30	9.20	9.05	*-0.6*	*-1.6*
EUR/NOK	9.49	9.50	9.40	9l30	*0.1*	*-0.9*
USD/SEK	8.50	8.61	8.76	8.70	*1.3*	*3.1*
USD/NOK	8.62	8.80	8.95	8.94	*2.0*	*3.8*
EUR/CHF	1.10	1.10	1.11	1.12	*0.4*	*1.3*
CHF/SEK	8.54	8.45	8.29	8.12	*-1.0*	*-2.9*
EUR/JPY	123	130	132	133	*5.2*	*7.4*
GBP/USD	1.41	1.42	1.35	1.38	*0.7*	*-4.6*
GBP/SEK	12.00	12.24	11.79	12.00	*2.0*	*-1.7*

**Currency forecasts were made by SEB Trading Strategy as of February 23, 2016. Please ask for a copy of our current forecasts.*

Currencies

Theme – China FX policy generating flows with major impact on markets

Economic developments in China and the country's exchange rate policy in particular – along with global commodity trends – have been strong factors contributing to the financial market turbulence that has dominated early 2016. Given China's economic growth rate and ever increasing integration with the rest of the world, changes in its currency policy have a major global impact – in both real and financial terms. Large capital flows have been set in motion – and more will follow.

Financial market turbulence gives the impression that changes in China's exchange rate policy are something new. In fact, a number of changes have been implemented since 1948, when the yuan was introduced. They include the pegging of the yuan to the dollar in 1997-2005 and 2008-June 2010, when the People's Bank of China (PBoC) increased exchange rate flexibility. After the financial crisis, an appreciation phase began, leading to large-scale currency inflows driven by expectations of continued appreciation (hot money inflows). To thwart this trend and make the market understand that the yuan can depreciate against the dollar, the central bank devalued the yuan in the spring of 2012 and in early 2014. This created market turbulence, which spread after the unexpected devaluation in August 2015.

One task of currency policy is to ensure a country's competitiveness. In China's case, there are few signs of weakening competitiveness, and the country has kept its share of world exports. Instead, the changes in currency policy should be seen as part of the country's long-term objective: to have a freely floating global currency. To accomplish this, exchange rate changes must be market-driven, which rules out large-scale market interventions. The yuan's close pegging to the dollar must also end. The August devaluation was part of a strategy to give the market a bigger role in setting the exchange rate. The International Monetary Fund (IMF) also noted a year ago that the yuan is no longer undervalued.

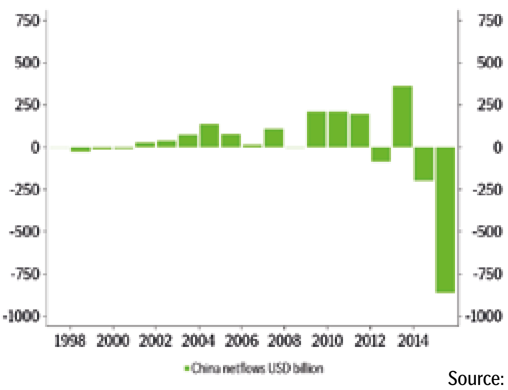
China's currency policy changes, and the likely end of the yuan's 10-year appreciation – which has made the currency 50 per cent stronger in real effective exchange rate terms – are creating new rules of the game. China and the rest of the world now face a large new currency risk element that is generating enormous capital flows. China's 2015 current account surplus is expected to have been around USD 350 billion. This was not enough to offset other capital flows. The PBoC's currency reserve decreased by about USD 515 billion. This means that the total capital outflow from China was a staggering USD 865 billion.

It is difficult to make an outflow forecast for 2016, but an amount close to what was recorded in 2015 cannot be ruled out. China reveals no details about the structure of its currency reserve, but various reports suggest that up to 60 per cent may consist of US government securities. Given a continued decline in the currency reserve, China will therefore need to sell fixed income instruments, which poses a clear risk of rising global long-term yields. Together with the fact that many oil producers need to use their financial reserves due to low oil prices, global asset markets are expected to be generally pushed down by securities sales.

Because the Chinese yuan will be included in the IMF's special drawing rights (SDR) currency basket as of October 1, central banks are expected to become more interested in buying the yuan. Central bank SDR assets can be estimated at USD 280 billion dollars. Given the yuan's 11 per cent weighting in the SDR basket, central banks will need to buy about USD 30 billion worth of yuan. These purchases are likely to take place gradually but cannot cover the outflows noted above.

To sum up, there is great uncertainty about the Chinese authorities' ability to defend the exchange rate since there are large capital outflows. In our view, the risk of a more uncontrolled depreciation is exaggerated and market sentiment will stabilise. However, the yuan will continue to weaken gradually in 2016. The risk of rising global long-term interest rates and yields will increase as China increasingly needs to sell fixed income instruments from its currency reserve, assumed to include a large percentage of US government securities. Combined with the need for oil-exporting countries to cover the budget deficits created by long-term low oil prices, this will put pressure on asset markets.

MASSIVE CAPITAL OUTFLOWS REDUCING CURRENCY RESERVE



Source: Bloomberg

Total capital outflows from China were a staggering USD 865 billion in 2015, and similar figures cannot be ruled out in 2016, which would put upward pressure on global long-term yields.

Discretionary asset management

IP Target portfolios

In the last Investment Outlook, *we painted a generally positive macro picture for 2016 and reached the conclusion that there would be a positive trend for risk assets this year. Our positive approach was primarily based on the thesis that lower commodity prices boost private consumption, which should offset declining industrial activity. At this writing, however, we can state that the continued fall in commodity prices is raising questions about the strength of global economic growth, which has also been reflected in asset values. In the absence of evidence that the macro picture is brightening, we chose to reduce exposure to equities in our portfolios early in January, which has turned out to be a good move. Compared to 6-12 months ago, we thus have a clearly more cautious approach in our portfolios today. At the same time, we see that the prevailing market turbulence has created attractive valuations in such asset types as corporate bonds in the high yield (HY) segment. We have marginally adjusted our fixed income exposure accordingly.*

- Positive performance for the full year 2015.
- Gradual risk reduction in the portfolios over the year.
- Fundamentally positioned for global growth.

RISK LEVEL/ STRATEGY	T+ 2	T+ 4	T+ 6
LOW – Government bonds, investment grade corporate bonds, low-risk hedge funds	0-100%	0-90%	0-70%
MEDIUM – High yield corporate bonds, emerging market debt, convertible bonds, medium-risk hedge funds	0-50%	0-50%	0-70%
HIGH – Equities, commodities, real estate investment trusts (REITs), listed private equity	0-10% commodities	10-40%	30-70%

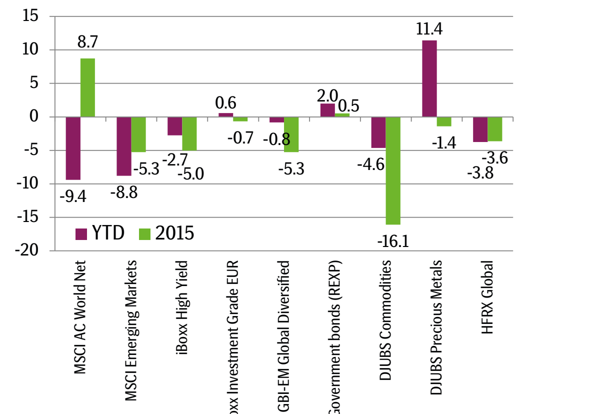
Strategy summary

Last year ended on a negative note. For 2015 as a whole, only shares in mature markets generated a positive return. Thanks to our strategy of avoiding commodities and commodity-related assets such as emerging market (EM) shares and EM currencies – and late in the second half of 2015 also American high yield bonds – our portfolios showed positive full-year returns. So far this year, financial market performance has been a continuation of fourth quarter 2015 trends, except that gold has climbed in value. Since August, we have progressively reduced our portfolios' risk level and sensitivity to global economic trends. In early January, we lowered risk further by reducing our exposure to equities. Compared to last summer, we now have more cash and a lower proportion of equities. In line with SEB's economic forecasts, however, the portfolios are fundamentally positioned for global growth, which means that we are not immune to the prevailing market turbulence.

Low-risk allocation

We have been reluctant to buy government bonds because they do not pay any significant yields, and we are sticking to that strategy (German 10-year bonds currently yield 0.2 per cent). The same argument has applied to investment grade (IG) bonds, because their low yields hardly constitute a buffer if yields start to rise. Instead, in Target +2 and +4 we have focused on absolute return fixed income managers who are able to take both long and short interest rate risk positions. Some of these managers have not lived up to our expectations, and in February we sold a few holdings. Our analysis shows

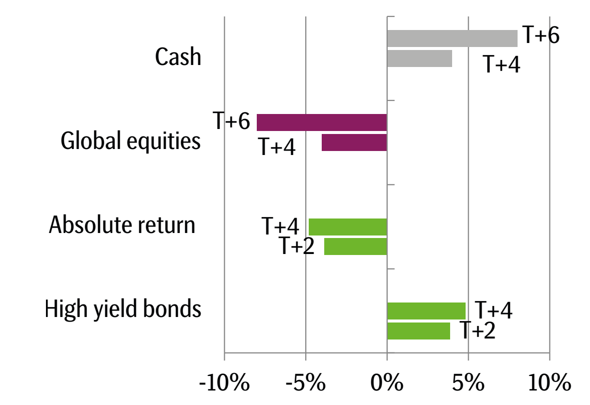
PERFORMANCE OF MAIN ASSET CLASS INDICES



Source: Bloomberg

The chart shows price changes so far this year (until February 19, in EUR) in selected asset types, based on major indices.

CHANGES IN ALLOCATION



Source: SEB

The bars indicate the changes we have made in asset allocations since the last issue of *Investment Outlook* in November/December 2015.

that some managers have directly or indirectly increased their exposure to riskier fixed income securities – such as government bonds from southern Europe and emerging markets – making the profile of their funds more like high yield. We have replaced these managers with high yield managers who have a low exposure to commodities. On paper, it looks as if we have increased risk, but in practice the level of risk is virtually the same, since the high yield sub-portfolio we are buying is of a defensive nature.

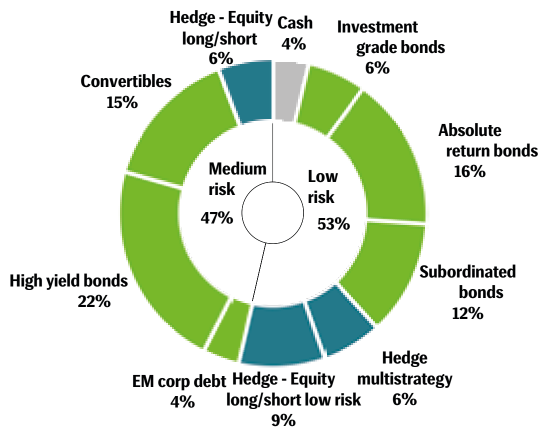
Medium risk allocation

As mentioned above, we have boosted high yield exposure by 4-5 per cent in Target +2 and +4, without actually increasing overall risk significantly. Returns in the high yield segment are now at levels that indicate an expected recession in the US and Europe, making this asset type especially attractive since we expect continued growth. We have increased our holdings in both European high yield – which structurally has low exposure to commodity companies – and US high yield managers with low commodity exposures. The hedge fund sub-portfolio has shown a mixed performance so far this year but is on the plus side as a whole. Our equity long/short holdings are down by 2.3 per cent overall, with two of the managers showing negative returns, while our systematic multi strategy manager has delivered 1.2 per cent and our CTA manager's investments have risen 6.2 per cent. This part of our portfolio is doing what it is supposed to do – providing stability and returns in an environment where other assets are performing sluggishly. We are keeping a close eye on our equity L/S managers, but we have not yet seen any reason to sell off these investments.

High risk allocation

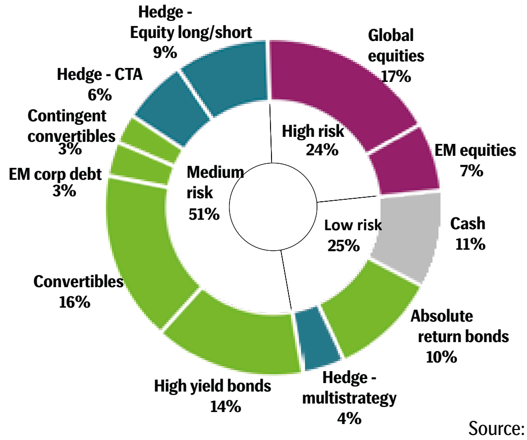
This portfolio consists mainly of equities in mature markets, but it also has selective exposure to Asian emerging markets and so-called frontier markets (FMs), both with a focus on domestic consumption. In mature markets, we reduced our holdings of equities with high dividends late in November as the US Federal Reserve's key interest rate hike was approaching, since equities with high dividends tend to perform more weakly in a period of interest rate hikes. However, we have not made any changes in our holdings with exposure to EM and FM assets. After a couple of weak days early in 2016, we decided to reduce risk in the portfolio, since we still lacked data supporting the consumption growth thesis. We reduced the equity sub-portfolio by over 10 per cent (4 percentage points in Target + 4 and 8 percentage points in Target + 6). Equity exposure now stands at 24 and 44 percent, respectively, which is below a long-term neutral weighting. Due to prevailing market turbulence, our sale proceeds are in cash, but we are looking at the best way to invest them without taking too much cyclical risk.

Target + 2 PORTFOLIO ALLOCATION



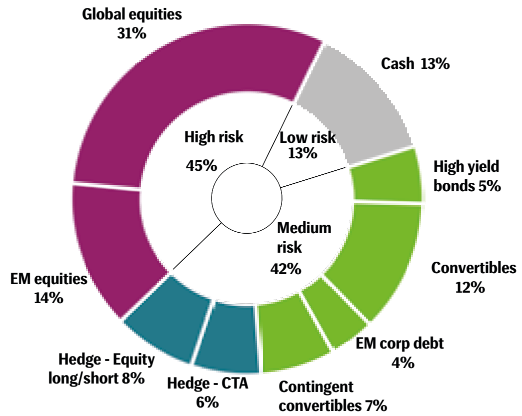
Source: SEB

Target + 4 PORTFOLIO ALLOCATION



Source: SEB

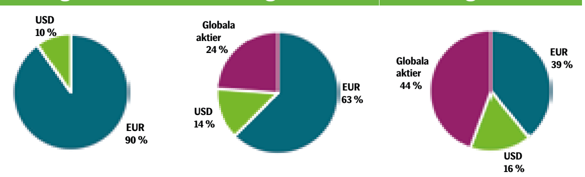
Target + 6 PORTFOLIO ALLOCATION



Source: SEB

CURRENCY EXPOSURE

Target + 2 | Target + 4 | Target + 6



Source: SEB

Currencies

Contrary to our forecasts, the US dollar has weakened this year. Moreover, the EUR seems to have changed character as a result of now having become a funding currency – investors are borrowing cheaply in EUR and buying assets, for example, in USD. But when risk appetite fades, they are buying back EUR to reduce their risk exposure. The EUR consequently tends to appreciate during periods of market stress. Our forecast nevertheless remains unchanged: the USD should appreciate over time, driven by the interest rate differential between the US and Europe. We also view the USD as protection against the potential risks that may originate from Europe, such as political collapse and the dissolution of the euro zone. We have therefore chosen to maintain our US dollar exposure.

Theme
Growth, earnings and returns

Several years of lower real economic growth and problems getting inflation to accelerate have made it more difficult for companies to increase their earnings. Furthermore, there are structural reasons that suggest we are also facing a period of low economic growth, low inflation and thus low nominal corporate earnings increases over the next couple of years. How will this affect expected returns and in what sectors and markets will we find the relative winners?

- There is lower potential for nominal earnings growth, due to low inflation and low real economic growth.
- Expected returns on all asset classes are falling.
- Major reallocations are occurring in investor portfolios.
- Growth companies and companies with good dividend-paying capacity are favoured over government bonds.
- Excessively weak growth will increase the risk of falling earnings and a recession.
- Nasdaq stands out in growth terms, but risk has increased due to its high concentration on a small number of companies.

During the financial crisis of 2008/09, economic activity around the world collapsed and earnings plummeted. In the following years, central banks and governments made enormous efforts to stabilise the financial system, boost global growth and prevent deflation. This approach worked well until 2014, when we began to see increasing signs that neither growth nor inflation expectations were being met. The same is now true of aggregate corporate earnings growth. To understand these developments, it is important to distinguish between cyclical and structural drivers.

In recent years the economic trend has been divided, to say the least, with the "China effect" clearly having an adverse impact on cyclical elements of the global economy such as commodities and manufacturing.

GDP – ANNUAL PERCENTAGE CHANGE	2015	2016	2017
United States	2.4	2.4	2.7
Japan	0.6	1.0	0.5
China	6.9	6.5	6.0
Euro zone	1.5	1.9	2.0
Sweden	3.6	3.7	2.8
The world (PPP)*	3.1	3.4	3.8

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

Source: SEB

The fantastic environment that prevailed for many years, with enormous investment-driven growth in emerging markets and surging commodity prices, led to strong earnings but also large production capacity increases, which in recent years have had the exact opposite effect – falling prices and very weak earnings. This is an excellent example of structural effects. Meanwhile, in recent years we have had stable, strong growth in the service sector, which is explained by healthy real wage increases via low inflation and record-low interest rates as well as a favourable labour market. In this context, central bank moves to drive down interest rates around the world have had a strongly positive effect.

As a result of this dual-track economic situation in recent years, the total real growth rate (excluding inflation) has been modest. Over the next two years, we expect a somewhat higher earnings growth rate, but in a slightly longer perspective we believe structural forces such as demographics and productivity will have an adverse effect. This means that the more long-term real growth trend, which is adjusted for annual cyclical factors, is heading downward. A commonly held view is that we should expect growth to be half a percentage point lower going forward (compared to the forecasts in the table).

How is lower projected trend growth reflected in expected returns?

With some kind of recovery expected in economic growth and inflation over the next two years, equities and corporate credits should deliver higher expected returns than, for instance, government bonds, which show very low yields – one effect of modest inflation forces and central bank asset purchases. This is normal, of course, since investors expect compensation for taking a higher risk.

Should this trend become a reality, investors will continue to look for investment opportunities that can match what government bonds once delivered – stability as well as both nominal and real returns. More and more investors are currently trying to achieve this by locking in investments for a longer period (and thus earning higher yields as compensation) or by investing in companies that have high dividend yields or coupons through the stock or bond markets.

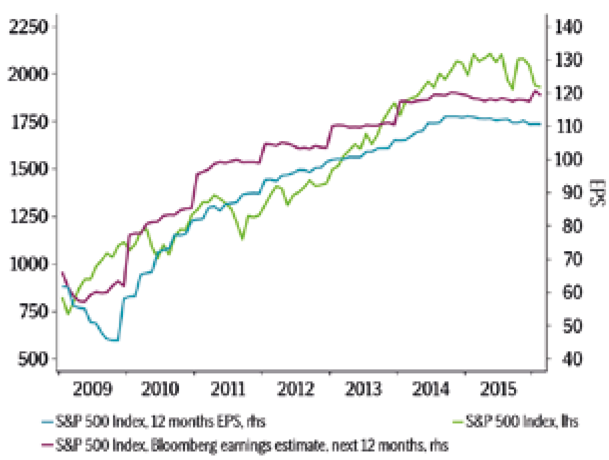
Another strategy is to look for companies that can generate much stronger than average earnings and that are preferably also less dependent on the business cycle. This strategy favours equity investments. So why have investors reduced their equity holdings in favour of government bonds and pure cash holdings in the past year? There are a number of reasons: valuations were high for a year in a historical perspective, there were serious concerns about the economy, and company earnings did not meet expectations. The chart to the right shows that these concerns were not unfounded.

Earnings – what are they and how do they change?
When we look at the structure of earnings, we can make the basic assumption that earnings equal revenue times profit margin. Over time, the interaction between these factors normally determines a company's profitability. However, other factors are involved, such as funding costs, extraordinary income and non-recurring costs.

Studying these fundamental factors, we can see that the revenue trend during the economic upturn of the past few years has been weaker than in many previous upturns – which means that GDP growth has not accelerated as much as in many earlier booms. This has been offset to some extent by rising productivity and cost saving programmes, which have boosted profit margins. In recent years, revenue has only risen marginally. The end result is that total earnings at the aggregate level are essentially unchanged.

While total earnings have largely stayed the same, we have seen an upturn in earnings per share. For example, in the S&P 500, this is explained by company share buy-backs, which have been significant over the past three years. The fact is that earnings per share would have also trended negatively during that time if buybacks had been at a more historically normal level. Due to strong company balance sheets, conditions remain favourable for continued buybacks. The earnings per share metric can thus be propped up for another while.

EARNINGS EXPECTATIONS DRIVE STOCK MARKET



Source: Bloomberg

The chart shows the S&P 500 stock market index in the US, the corporate earnings trend and earnings forecasts for the past seven years. Downward revisions and earnings disappointments are reflected in falling share prices, whereas expectations of increased earnings and the realisation of such expectations cause share prices to rise.

Earnings vary between sectors
The dual-track global economic trend is also apparent when comparing the performance of different sectors over the past few years:

- The importance of the industrials sector has decreased.
- The commodities (materials) sector has seen an upturn and a downturn.
- The information technology (IT) sector has seen the reverse pattern, with a downturn and an upturn.

The chart on the right hand side illustrates total earnings generation of US listed companies and each sector's contribution to total earnings.

ASSET CLASS	LONG-TERM RETURNS GENERATED, %	EXPECTED RETURNS WITH CONSTANT YIELDS, %	RISK MEASURED AS STANDARD DEVIATION, %
Treasury bills	3.0	-0.1	1.0
Government bonds	4.3	0.5	5.4
Corporate bonds	5.5	1.8	5.4
Equities	8.0	4.3	17.4
Commodities	5.8	2.0	16.5
Real estate	5.5	1.8	12.7
Hedge funds	5.1	1.9	6.6

Source: SEB

The table shows returns generated, expressed as a 30-year average, and the risk for each asset type. Column two adjusts these historical returns by factoring in current interest yields, which revises expectations downwards in nominal terms. If we also factored in assumptions of lower future trend growth, further downward adjustments would be needed.

In a "low everything" environment – with low inflation, low interest rates, low yields, low economic growth and low earnings growth – it is important to seek out well managed companies that have good potential to generate growth on their own. For instance, the Swedish stock market has turned out to be a good investment over time and has fared well in different types of market situations. That suggests it consists of high quality companies that generate good growth in both revenue and earnings over time. The disadvantages are that the Nasdaq OMX Stockholm exchange is small and that it is underexposed to defensive sectors; as a result, it is generally stronger than the world index in rising markets and weaker in falling markets. From a portfolio perspective, it is therefore suitable to supplement a portfolio of Swedish equities with a global exposure.

The search for growth leads to the Nasdaq
The composition of companies on the US-based Nasdaq stock exchange has made it a winner over time and is a factor in its favour if we are entering an environment of even lower growth. Some of the positive drivers on the Nasdaq are that:

- It is made up of growth-oriented sectors.
- It includes many of the world's fastest-growing listed companies.
- It includes many companies with good profitability and low tied-up capital.
- It is a growth engine where many new growth companies want to be listed and "old" growth companies are constantly buying up new ones.
- Silicon Valley and US universities are strong clusters in the IT sector.

However, every now and then, pricing on the Nasdaq becomes too challenging and the exchange loses out to more defensive exchanges. In fact we are in such a period right now, but this is after several years of excessive returns. The charts below show the Nasdaq compared to the S&P 500 index as well as the current forward P/E ratios for each.

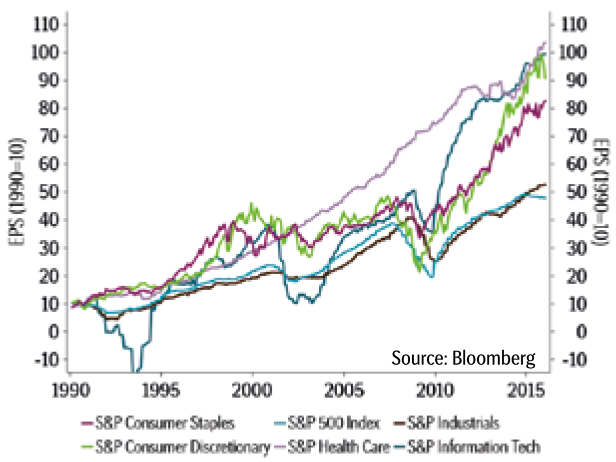
To investors that do not take the above arguments into consideration, Nasdaq valuations may look high. But given our reasoning, it may instead seem strange that the P/E ratios of Nasdaq and the S&P 500 – based on earnings forecasts for the coming twelve months – do not deviate from one another by more than three percentage points (18.5 for the Nasdaq versus 15.5 for the S&P 500).

One explanation is the ever-present concern that the very biggest companies on the Nasdaq may have peaked. The five biggest companies weigh heavily in the Nasdaq index and account for more than 25 per cent of total market capitalisation.

Is it worth the risk to maintain an exposure to Nasdaq over time? If history is any guide, the answer is yes, although investors should be more cautious if relative valuations climb too high. The dotcom (IT) bubble at the turn of the millennium is a good example of this, and it took a long time before Nasdaq recovered from the subsequent decline.

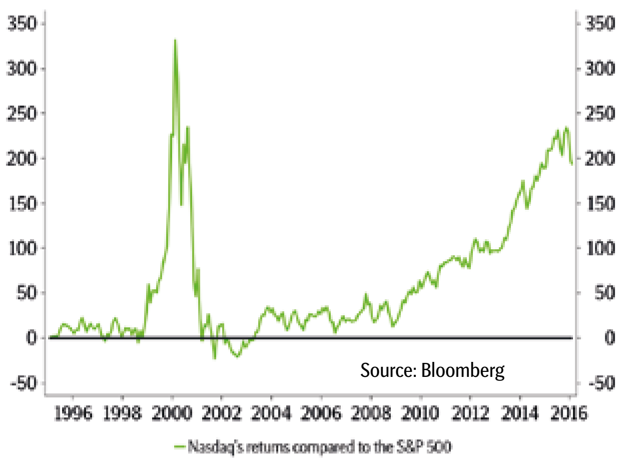
Nonetheless, the drivers behind these companies are so strong that it is difficult to refrain from exposure to Nasdaq as part of a global portfolio. The chart below shows the upturn in both revenue and earnings for the Nasdaq exchange and the S&P 500 index. Both have shown strength, but the revenue upturn for Nasdaq-listed companies is particularly impressive.

STABLE EARNINGS GENERATION IS REWARDED



The chart shows total earnings generated by US listed companies and the contributions of selected sectors to total earnings. Earnings for cyclical industrial and consumer durable companies fluctuate the most; pharmaceutical companies are more stable and also generate better earnings over time.

NASDAQ SHOWS STRONGEST PERFORMANCE OVER TIME



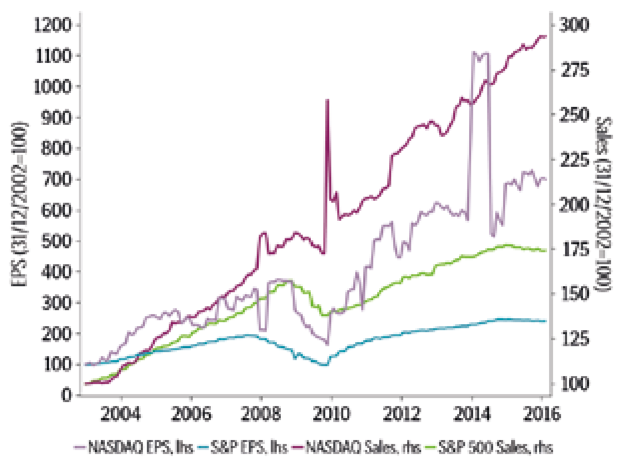
The tech-heavy Nasdaq exchange fluctuated sharply during the dotcom (IT) bubble, but since then it has far outperformed the broader stock market.

Conclusions

The ever weaker nominal economic growth of recent years has structural causes; there is reason to assume slower growth in the next couple of years as well. This means that investors will probably have to lower their future earnings expectations. This has already had a significant impact on pricing in the capital market.

For the time being, this weaker growth has been partly overshadowed by general worries about economic growth and the earnings cycle, which have made investors far more cautious. Should it turn out that the economy nonetheless manages to generate decent growth, investors will look to the stock market and the corporate credit market in their search for returns. In these segments, growth-oriented companies will be attractive, which means people will look, among other places, to Nasdaq. The exchange has become a gathering place for many of the world's most successful growth companies, which means that it also attracts many new growth companies. The other side of the coin is the risk of high concentration, with the five largest Nasdaq companies accounting for more than 25 per cent of the exchange's market capitalisation.

STRONGER GROWTH FOR NASDAQ COMPANIES



Source: Bloomberg

Both revenue and earnings have climbed far more rapidly for Nasdaq companies. The earnings trend in the broad market has been relatively weak in recent years, and even more so if large share buybacks are taken into account.

HIGHER VALUATIONS BUT NOT EXPENSIVE

Source: Bloomberg

It seems reasonable that higher earnings growth leads to higher valuations on Nasdaq. Today's differentials are not frightening – especially since valuations in the broad market are in historically record-high territory, unlike Nasdaq.

Theme – Oil

Larger price declines and effects than expected

After nearly four years of oil prices around USD 100 per barrel (Brent), by around the end of 2013 we started to become accustomed to this level, and our perception was that lower prices belonged to history. Late in the summer of 2014, however, a sharp decline in prices began and slowed only temporarily in early 2015. By then, prices had more than halved to about USD 45/barrel. The adjustment was very dramatic and generated great concern. This concern has since escalated and is now putting pressure on the world's financial markets. Oil prices are currently around USD 33/barrel.

- Years of oversupply have built up record-sized global oil stockpiles.
- American shale oil is a larger and more durable market player than expected.
- Saudi Arabia has continued to produce at record levels despite the fall in prices.
- Demand is still rising.
- Low oil prices have led to large fiscal deficits in oil-producing countries.
- The sovereign wealth funds of oil producers have been, and remain, major sellers in financial markets.
- The effect of sharply lower capital spending in the oil sector will be delayed.

The underlying reason for oil's resilience to the general fall in commodity prices that has prevailed in the past several years was the "Arab Spring" that began in 2010. Country after country faced demands for democratic reform, which led to great turmoil and forced various countries to cut back their oil production. Reduced production resulted in a supply deficit of 1.3 million barrels per day, propping up oil prices even though most other commodity prices were falling.

Meanwhile the United States emerged as an increasingly important oil producer as shale oil extraction soared. Expectations that US shale oil production would be only marginal proved to be a major miscalculation. During the period 2008-2013, it rose to 3.5 million barrels per day, equivalent to more than 10 per cent of production by the members of the Organisation of the Petroleum Exporting Countries (OPEC). High, seemingly sustained oil prices also made it profitable to produce oil even using costly methods, such as deep sea drilling and extraction from Canadian oil sands.

Demand has not been the problem

Increased supply, not weaker demand, is behind the collapse in oil prices. According to the International Energy Agency (IEA), daily global demand rose by 1.6 million barrels in 2015. The IEA estimates that demand will climb by another 1.2 million barrels this year. Total world demand is currently around 94 million barrels per day.

Oversupply is a fact

The production of shale oil has been steadily increasing and is currently several million barrels per day. Furthermore, new high-cost oil production is now underway, while previously suspended production segments in Arab and other Middle Eastern countries have again started up. The consequence has been an oversupply in the oil market – in 2015 it was more than 2 million barrels per day – with a sharp price decline as a consequence. Daily production is currently about 1.5 million barrels too high.

Historically, Saudi Arabia has varied its output in order to balance the market and stabilise prices. This time around such a policy would require rather significant cutbacks, so the country has instead adopted a strategy of maintaining the country's near-record production – probably based on the assessment that although lower oil prices would be negative for the country in the short term, high-cost oil production would eventually be eliminated and prices would then rebound. The focus was on defending market

OIL AND METAL PRICES SINCE 2010

Source: Bloomberg

The oil price decline of recent years has been dramatic, both in strength and speed. The slide in metal prices is almost as large but has occurred over a longer period. Reduced production was behind the resilience of oil prices compared to otherwise falling commodity prices, expressed in the above chart by West Texas Intermediate (WTI) crude oil and a base metals index.

share and making the production of, for example, American shale oil unprofitable. However, by early 2016 this has not yet happened, despite oil prices of around USD 30/barrel.

The biggest miscalculation was to underestimate the resilience of US shale oil production. Expectations of production cutbacks at much higher oil prices than today's did not materialise. Aside from adding new capacity to the market, shale oil production is more flexible. Using conventional methods, the lead time in order to start new oil production is about five years, but shale oil takes only three months. This factor is likely to hold back major long-term price increases. Another factor is swelling global oil stockpiles, which are at record levels today.

Production is decreasing, though at a slow pace
Although shale oil production has not decreased to any significant extent – only by an estimated 500,000 barrels per day since the peak – the total number of active oil rigs in the United States has declined sharply since the autumn of 2014. Statistics from the oil service company Baker Hughes in February 2016 showed that the number of active rigs had fallen for nine weeks in a row. The number is now 413 (compared to 662 as recently as last September), which is the lowest level since 2009. Because of major productivity improvements in the shale oil industry, production did not initially fall. But now the number of active rigs seems to be declining faster than productivity is increasing.

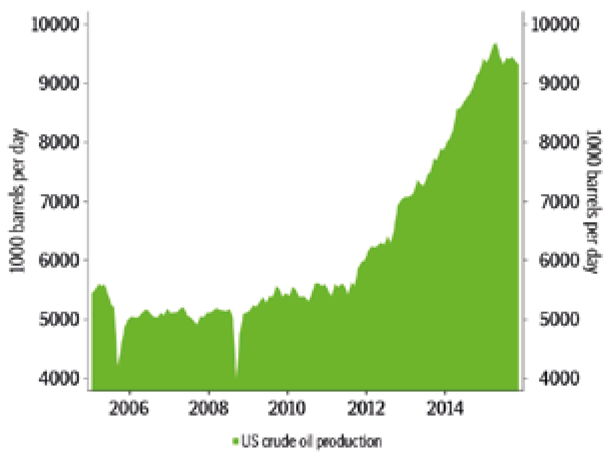
Furthermore, oil company investment budgets have declined sharply around the world. An SEB survey of 40 large oil companies indicates that these budgets have been cut by roughly 25 percent in both 2015 and 2016, which is the largest reduction in 30 years. This will have an effect, but only about 4-5 years from now.

Impact of the price slide
The perception that cheaper oil is negative for producers but good for consumers and leads to higher GDP is probably correct in the long term, but not in the short term. Of aggregate investments made by all listed companies in a normal year, energy and materials account for about one third. Globally, investments in oil and gas extraction have declined sharply from record-high levels. During the past two years alone, their level is expected to have decreased by USD 250 billion. According to IEA estimates, capital spending of around 650 billion per year is needed to ensure long-term market balance. However, this forecast was made when costs were higher than today, and USD 500-600 billion is thus probably a more reasonable figure. If so, this means it will take until 2017 before under-investment becomes a reality.

Not only are oil companies and their suppliers facing tough challenges, but their lenders are also affected. The total volume of bonds issued by oil and gas companies, according to estimates from the Bank for International Settlements (BIS) has risen by about 15 per cent a year since 2006 and now amounts to a huge USD 1.4 trillion. In addition to bonds, syndicated bank loans (with several banks joining forces and granting loans) for these sectors have increased by 13 per cent annually. Bank loans are in the range of USD 1.3 trillion. We have not yet seen any major impact from this, but the risk of loan losses will increase the longer oil prices remain at current levels.

Another significant effect of the sharp drop in prices is on oil companies' balance sheets. As oil prices have fallen, the total value of proven oil reserves has fallen by about USD 135 trillion (equivalent to 140 per cent of global GDP!), which has dealt a hard blow to company balance sheets.

US OIL PRODUCTION OVER A 10-YEAR PERIOD



Source: Bloomberg

American shale oil production has greatly surprised the market, both in volume growth and resilience to falling oil prices. The above chart shows the trend of overall US oil production since 2006. The entire production increase since 2010 is explained by shale oil. The United States now produces almost as much oil as Saudi Arabia.

OIL PRICE TO ACHIEVE PUBLIC SECTOR BALANCE (USD/BARREL)

COUNTRY	BREAK-EVEN
Bahrain	106
Saudi Arabia	103
Algeria	95
Oman	95
Iran	87
Iraq	80
United Arab Emirates	73
Kuwait	67
Qatar	55

Source: IMF 2015

Oil countries' budgets increasingly strained

For many oil-producing countries, oil is their single most important source of income. Higher oil prices are therefore crucial to enable these countries to restore their government finances. According to a study by the International Monetary Fund (IMF), oil prices will need to be significantly higher than today if these countries are to achieve balanced budgets.

Today's oil price levels are resulting in budget deficits, which must be compensated for. According to an analysis by JP Morgan ("Flows & Liquidity", dated January 15, 2016), during 2015 oil-producing regions (the Middle East, Norway, Russia, Africa and Latin America) earned oil export revenues of around USD 740 billion. This was about USD 70 billion less than would have been required for balanced budgets. If oil prices remain at around USD 30/barrel in 2016, revenues will end up at around USD 440 billion, which would lead to deficits in the range of USD 260 billion. Historically, oil revenues have mainly been used in two ways: to import goods and services and to buy financial assets, the latter mainly through sovereign wealth funds. The consequence of the decline in oil prices for this group of countries was that they consumed USD 70 billion more in 2015 than their oil exports allowed for. This was solved by tapping their foreign exchange reserves and by selling off financial assets.

Stock markets also affected

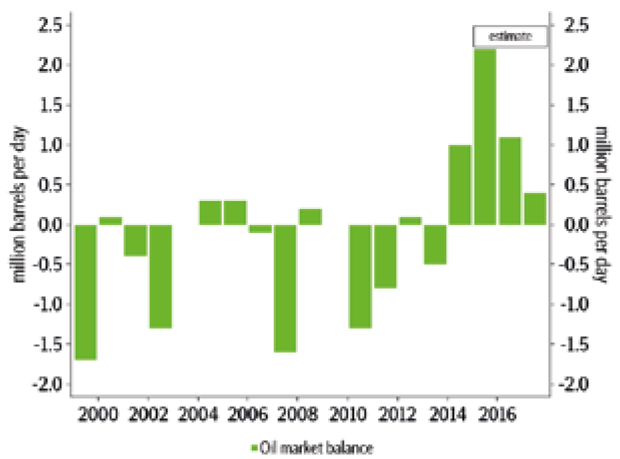
In financial markets, the oil-exporting countries are now net sellers, having previously been net buyers. This is one reason why oil price increases have become more and more closely correlated with stock market upturns. The JP Morgan report noted that a disproportionate percentage of oil countries' sovereign wealth funds consist of exposure to Western Europe, with a significant overweighting in financial, technology and consumer durable shares. These have been three of the worst-performing sectors in the stock market during 2016.

What can we expect ahead?

Most OPEC members will probably not increase their oil production during 2016. Saudi Arabia, Russia, Qatar and Venezuela announced on February 16 that they had agreed to freeze production at the level prevailing in January, provided that other producers also do likewise. The agreement is not a huge sacrifice for Saudi Arabia, which is already producing at record levels, nor for Russia, which is pumping at its highest level since the Soviet era. Iran, however, has indicated that it wants to restore the production levels that prevailed before international sanctions were imposed against it. The country needs oil export revenue, which means that a freeze in oil production at its current level seems unlikely. Although market players had hoped for a decline in output, the above agreement is still a good signal. It marks the first time in 15 years that OPEC has reached an agreement with non-OPEC members about a shared commitment.

We have adjusted our forecast for 2016 downward and now expect demand of about 95.8 million barrels per day. That implies a persistent oversupply of more than 1 million barrels per day, but we believe that a continued rise in demand combined with stable (possibly slightly decreasing) supply will bring the market closer to balance during 2017. Oil prices will probably bottom out some time in the first half of this year and then rise somewhat. Because of the flexibility of US shale oil production, however, we do not believe there will be any sharp and/or long-lasting price increases.

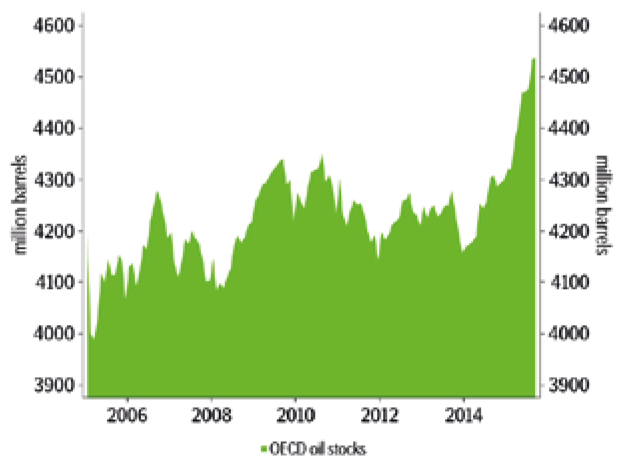
FROM UNDERSUPPLY TO OVERSUPPLY OF OIL



Source: Bloomberg

As the above chart indicates, years of undersupply predominated in the oil market from 2000 until 2013. In subsequent years, oversupply has prevailed. We believe that last year's imbalance – more than two million barrels per day – was the peak and that the market will again move closer to balance by late 2017.

OECD OIL STOCKPILES SINCE 2006



Source: Bloomberg

Several years of oversupply in the oil market have swelled global oil stockpiles, which have now reached record levels. The chart shows the size of stockpiles in the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) since 2006, including strategic stockpiles of about 1.5 billion barrels.

Theme - Brazil

When the samba ends...

...the headaches begin, and what was recently such a buoyant economy now appears in a completely different light, with serious structural and cyclical problems. Brazil was one of the countries that benefited most from China's enormous demand for commodities early in the millennium. It is now one of the countries hit hardest by declining demand. The country's attractiveness to international investors has waned considerably, and the Brazilian real has lost as much as 60 per cent of its value against the US dollar since it peaked in 2011. Brazil no longer looks like a robust economy but instead seems as fragile and volatile as before the term "BRIC" was coined.

- Recession or depression? The economy is rapidly shrinking – for how much longer remains to be seen.
- After the borrowing spree of recent years, will the banking system be able to handle a shrinking economy?
- Political chaos is not inspiring any hope. Who has the strength and time to deal with the country's economy when everyone seems to have been drawn into a web of endless corruption scandals?
- China's economic rebalancing has led to structurally lower mineral prices, but the downturn has stopped.
- Export giants Petrobras and Vale have lost their former lustre but are no longer crucial to the country's stock market performance.

The economic revolution in China over the past few decades had a big impact around the world. For many mineral-rich economies it was considered a blessing, since China's enormous appetite for all kinds of commodities drove up prices by several hundred per cent during the first 7-11 years of the new millennium. Developing economies with large mineral assets were transformed into "emerging markets", which in many respects outperformed richer countries in the West in terms of key macroeconomic indicators and investor attractiveness. Today, with the prices of commodities like oil, aluminium and iron ore again reaching 2003 levels, the situation is totally different. The countries that benefited most from China's massive investments are also those hit hardest by the reshaping of the Chinese economy, with its greater emphasis on services and private consumption.

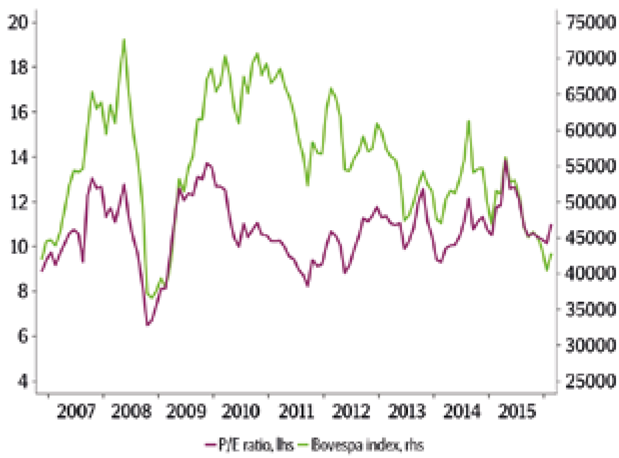
From robust to fragile when BRIC fairytale ended

One of the really big winners from surging commodity prices during the first decade of the millennium was Brazil, but today the country's attractiveness to international investors has waned considerably. The Brazilian real, which not long ago looked like it might become a new hard currency, has lost more than 60 per cent of its value against the US dollar since its 2011 peaks (even compared to the much weaker Swedish krona, the real has lost half its value). Just a few years ago, Brazil attracted such large foreign capital inflows that President Dilma Rousseff publicly attacked the US Federal Reserve and its ultra-loose monetary policy, which was thought to be driving excessive capital flows to Brazil. Today Brazilian government bonds are classified as junk bonds, and the market capitalisations of the country's two biggest export companies, Petrobras and Vale, have shrunk to less than a tenth of their value five years ago.

Are there any bargains, or is it time to give up?

Are there bargains to be had on the São Paolo stock exchange or is the worst still ahead of us? The single most important factor in answering this question is whether Brazilian banks will survive the country's economic recession without an explosion of credit losses. The banking and financial service sector today makes up 26 per cent of the exchange's index and accounts for a far bigger share of earnings. Today the banks are valued at a price/earnings

P/E RATIO AT THE SAME LEVEL AS IN 2011



Source: Bloomberg

The stock market downturn in Brazil is explained mostly by worse earnings prospects, with the P/E ratio at the same level as in 2011. The chart shows the Bovespa stock index and the consensus P/E ratio forecast for the coming 12 months.

(P/E) ratio of about 6 – based on the consensus earnings forecast for 2016 – since some investors fear a scenario similar to the one in Sweden in the early 1990s and in the Baltic countries in 2009, when large profits turned into even larger losses due to runaway loan defaults.

Even if a "financial crisis" with runaway credit losses for banks can be avoided, it is important to remember that the stock market downturn of recent years was caused by downgraded earnings forecasts for listed companies. The reasons why these forecasts were cut are both structural (long-term) and cyclical (rebounding in a couple of years). It will probably be a very long time, if ever, before various metal prices will again be as favourable to Brazil as they were three years ago. After revelations in recent years about the enormous Petrobras corruption scandal, and given the farcical political situation in the country at present, even in a very positive scenario it will be a very long time before investors regain the confidence in Brazil they had in 2011. It is reasonable to expect that investments in Brazil will require a significantly larger risk premium in the foreseeable future than was the case then.

Petrobras and Vale

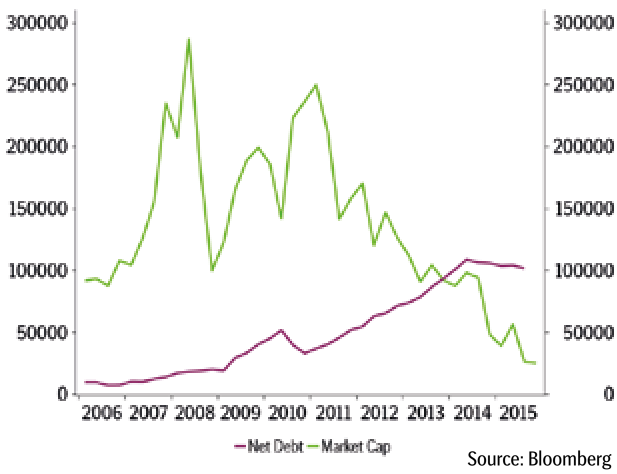
The crises at Petrobras and Vale have already done so much damage that these companies' shares now have quite a limited impact on the São Paolo stock exchange, with index weightings of around 5 per cent each. However, two such large industrial companies naturally also have a significant indirect impact on both the real economy and on investor and business confidence.

Even after sharp cuts in its capital spending budget, Vale is planning investments of more than USD 6 billion this year, and Petrobras intends to invest USD 100 billion over the five-year period 2015-2019. Petrobras and Vale have a combined total of about 150,000 employees, but they indirectly employ far more people including suppliers.

The two companies have dominant positions in Brazil's oil and mining industries, respectively; Vale is the world's largest iron ore producer, while Petrobras completely dominates the country's oil industry with its daily output of more than two million barrels. Both companies are also highly leveraged, with net liabilities equivalent to about two times and more than five times their market capitalisation, respectively. As a comparison, the most heavily indebted industrial company on the Stockholm stock exchange has net liabilities of almost twice its market cap, which is enough to generate considerable speculation today about an imminent emergency bond issue by that company.

Just as Brazil is a good example of a country that has been vulnerable to fluctuating mineral prices over the past decade, Petrobras and Vale are good examples of how a lot of large companies have been hit by the same phenomenon. There are many large (and small) oil and mining companies around the world that acted quite rationally a few years ago based on prevailing market conditions but which today are struggling with enormous debt, while the return on oilfields or mines they invested in using borrowed capital has been much worse than expected. There is a long list of big mining and energy companies that have made the same mistake, which is a major cause for concern in the credit market today. In some cases, these large-scale investments in new mines were supplemented with company acquisitions funded by borrowings, which have further aggravated the situation. Concerns about these heavily indebted mineral producers and their suppliers are a key factor in the credit market turmoil that has shaken the world over the past six months.

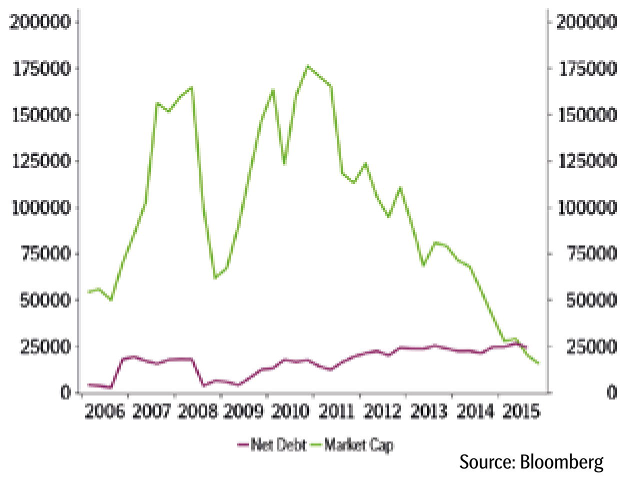
ESCALATING NET LIABILITIES AT PETROBRAS



Source: Bloomberg

The chart shows Petrobras' market capitalisation and net liabilities in millions of dollars. The sharp depreciation of the real is helping the company offset lower oil prices with lower costs for domestically produced services, but large costs – especially interest on the company's USD-denominated borrowings – must still be paid in hard currency. Five years ago, Petrobras' net liabilities were more than USD 40 billion and its market cap was USD 250 billion. Today, its net liabilities are more than USD 100 billion and market cap is less than USD 20 billion.

COLLAPSE FOR IRON ORE GIANT VALE



Source: Bloomberg

The chart shows Vale's market capitalisation and net liabilities in millions of dollars. Five years ago, market cap was 10 times greater than net liabilities; today net liabilities are roughly twice as high as the company's market cap. The share price has totally collapsed due to the fall in iron ore prices, and the company is highly leveraged.

And just as Brazil is a good example of how extremely favourable macroeconomic conditions only a few years ago led to aggressive investments in many mineral-rich developing countries – sometimes funded by borrowings – Petrobras and Vale are clear examples of the same development in the corporate world. Another common feature is the subsequent dramatic deterioration in external conditions due to steep price declines for oil, iron ore and other minerals. Today shares in both companies are much like options; dramatically higher prices of oil and iron ore, respectively, would cure most of these companies' headaches (although Petrobras will continue to be dragged down by the repercussions of its bribery scandal for a long time). Meanwhile, current prices make the companies "creditors" for all practical purposes.

Brazilian banks

Although Brazil's economy is closely tied to its major export products – soya beans, sugar cane, iron ore and oil – by far the most important sector in the country's Bovespa stock index is banking. Banks make up 26 per cent of the index, whereas energy, including Petrobras, accounts for 9 per cent, and commodities, including Vale, account for 11 per cent. The food sector also weighs heavily, at 17 per cent of the index but is mainly represented by the brewery company AmBev and the food processor BRF. Brazil's thriving agricultural sector has no representative among large-cap listed companies.

If we are to believe analysts, Brazil's banks will manage the current recession just fine. The biggest banks included in the stock market index are Itaú Unibanco, Bradesco, Santander Brasil and Banco do Brasil. Earnings of all four are expected to increase again in 2017, after an earnings decline of between 10 and 30 per cent for three of the four and unchanged earnings for the fourth in 2016.

The low P/E ratios (three of the big banks are valued at a P/E ratio of between 3 and 7, based on consensus earnings forecasts for 2016) are certainly attractive. Yet they also reflect the fears of many investors that the current recession, which follows more than a decade of sharp credit expansion, will lead to big credit losses, perhaps far bigger than analysts' consensus forecasts indicate today.

Summary

Brazil is a clear example of how in hindsight, the super-cycle in the commodities sector during 2003-2012 – with China as the main driver and given the subsequent collapse – was not the economic blessing it appeared to be a few years ago. Since its peak, the stock market index has fallen by 40 per cent in local currency. The downturn is explained by worse corporate earnings prospects, which are not only due to the business cycle. Among the factors that will be critical to the country's future economic growth are credit loss trends for banks and changes in mineral prices.

IMF FORECASTS FOR BRAZIL	2015	2016	2017
GDP growth, %	-3.8	-3.5	0.0
Inflation, %	8.9	6.3	5.2
Budget deficit, % of GDP	-7.7	-7.2	-5.4
Current account balance, % of GDP	-4.0	-3.8	-3.8

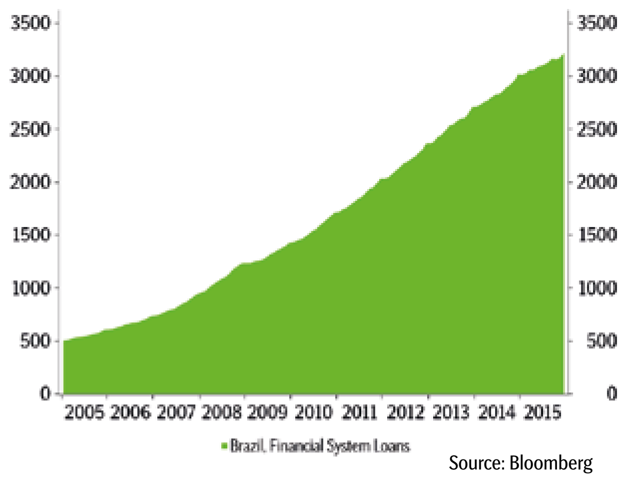
Source: IMF (GDP forecasts from January 2016, other forecasts from October 2015)

BRL'S LINK TO USD IS CREATING CAPITAL FLOWS

Source: Bloomberg

The chart shows the value of the Brazilian real against the US dollar. When confidence was at its peak, a dollar cost 1.5 reais and Brazil's president attacked the US Federal Reserve for causing excessive capital flows into the country. Today, a dollar costs 4 reais, and no one is complaining any more about capital inflows.

RUNAWAY BORROWINGS OVER THE PAST DECADE



Source: Bloomberg

The chart shows total borrowings in the Brazilian banking system according to the country's central bank. Over the past 10 years, total borrowings have increased by more than 500 per cent to 3,217 billion reais. Not only mining and oil companies have borrowed to fund capital spending; the good times fuelled credit growth throughout Brazilian society.

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