Investment Outlook

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SEB

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Higher growth and inflation rates

WE ARE FINALLY RECEIVING LONG-AWAITED SIGNALS that we have bounced back from the recent economic slump, with its mediocre growth rate and worryingly low inflation rate. In addition, there are hopes of support from fiscal policy initiatives, mainly via promises from the new president of the United States. Overall, this will form a solid basis for higher corporate earnings. So far the stock market has interpreted these developments in a positive way. The fixed income market is affected differently, since rising yields hurt returns on bonds with longer maturities. For corporate bonds, this may be offset by the fact that credit spreads (the difference between government bond and corporate bond yields) are favoured by prosperous businesses.

If this stronger trend persists, we should also have reached the peak of aggressive central bank support. This will affect the future performance of financial asset markets.

Last year began with great anxiety and high volatility and then gradually became calmer. This year has started with strong confidence and low volatility. Future developments will be exciting to follow, since financial markets will change shape and risks will be lurking around the corner. US President Donald Trump's aggressive stance on such issues as protectionism and trade barriers risks triggering a trade war, which may hurt global growth. Furthermore, what will happen if interest rates continue to rise while global debt is record-high and central banks gradually assume a more defensive posture?

Our interpretation of the above changes in market conditions and many other parameters is examined from various standpoints in this issue of *Investment Outlook.* As usual, we balance positive and negative forces when we present our views on what a portfolio should include, and in what proportions.

In our first theme article, we provide an update on the potential for fixed income investing in a continued low interest rate environment, but one where we are now seeing an upward trend in interest rates from historical lows. In our second theme article, we survey developments in the fields of sustainability and ethics and how these concepts are being integrated into the world of investing.

Wishing you enjoyable reading,

FREDRIK ÖBERG
Chief Investment Officer,
Investment Strategy

Market view
Summary

The economic picture has improved in most countries and regions – including commodity-producing countries that were previously plagued by major price declines, among other things for oil. In real terms the global growth rate is expected to climb from 3 per cent in 2016 to 3.6 per cent in 2017, while nominal growth will be higher than this because of rising inflation. So it is not at all unreasonable to assume that we may achieve corporate earnings growth of around 10 per cent this year, in line with forecasts, and that such an improvement will include most economic sectors. The trend towards a better growth outlook and upward adjustments in earnings forecasts has impacted valuations and returns. Equities – with cyclical positions generally experiencing a strong period – have performed better than bonds. In the fixed income market, corporate bonds have provided higher returns than government bonds.

We have adjusted our downside scenario, since the risk of recession and of a further period of meagre earnings has diminished. What is new is an increased risk of protectionism due to the Trump administration's many statements, as well as political risks related to elections in Europe this year.

A stronger economic situation also means that risk appetite has climbed, that central banks do not necessarily have to continue stimulating their economies as much but that rising interest rates may create a squeeze, since debt is still at record-high levels.

Since the last issue of *Investment Outlook* (published in December 2016) we have increased the risk in our portfolios by boosting the percentage of equities. We thus believe that not all the positive signals have been priced in; instead, there is reason to be optimistic about future performance as well.

ASSET	WEIGHT	TACTICAL EXPECTATION (12-MONTH)	
		RETURN	RISK
STOCK MARKETS			
Global equities	1 2 3 **4** 5 6 7	6.0%	12.4%
Emerging market (EM) equities	1 2 3 **4** 5 6 7	7.6%	12.4%
Swedish equities	1 2 3 4 **5** 6 7	8.8%	12.1%
FIXED INCOME			
Government bonds	**1** 2 3 4 5 6 7	-1.5%	2.9%
Corporate bonds, investment grade (IG)	1 2 **3** 4 5 6 7	1.2%	3.2%
Corporate bonds, high yield (HY)	1 2 3 4 **5** 6 7	3.1%	5.2%
Emerging market (EM) debt	1 2 3 **4** 5 6 7	4.8%	13.0%
ALTERNATIVE INVESTMENTS			
Hedge funds	1 2 3 **4** 5 6 7	N/A	N/A
Commodities	1 2 **3** 4 5 6 7	N/A	N/A
CURRENCIES			
CURRENCY PAIRS	**FORECAST ON FEB 1, 2017**	**Q1 2017**	**Q2 2017**
EUR/USD	1.08	1.10	1.06
EUR/SEK	9.42	9.40	9.30
USD/SEK	8.73	8.55	8.77

"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 January 11, 2017. 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.

IN THE LAST ISSUE OF *Investment Outlook* (published in December 2016), we recommended maintaining a slight underweighting of risk in our portfolios. Since then, we have moved to the other side of the neutral level and adjusted our risk to a slight overweighting. The main driver behind this change was signals of stronger economic growth and its positive effects.

The following is a review of a number of factors that now justify an overweighting in risk assets and our picture of how they may influence future developments.

Central banks: Continued low key interest rates and stimulative securities purchases, except in the United States, where the Federal Reserve (Fed) is planning a few key interest rate hikes yearly during 2017-2018. Sweden's Riksbank may also change its behaviour during 2017 due to rising inflation.

Growth and earnings: Clearly improved conditions for a rise in growth and inflation will create the potential for stronger corporate earnings in most sectors. There are hopes that active fiscal policy measures may contribute positively, offsetting gradually diminishing monetary policy support.

Valuations: Compared to historical valuations, currently prevailing levels are high. In relation to valuations of government bonds, valuations of equities and corporate credits are more normal, provided that economic growth lasts.

Risk appetite: Risk appetite has increased ever since the "oil crisis" during the first quarter of 2016, which is reflected in a large proportion of risk assets such as equities in many investors' portfolios. Because of this, we are holding back our risk exposure slightly, even though risk appetite is not yet at historical peaks.

Expected returns: As indicated in the table on the previous page, we continue to expect positive returns from most asset classes over the next 12 months. These expected returns are lower than the historical average, while risk is intact. The reason is the valuation parameter – which affects all assets – and rising inflation, which will undermine bond yields.

Examples of risks: Valuation levels, high global debt, signals of increasing protectionism, the potentially negative effects of rising inflation, interest rates and bond yields, possible frictions within the EU due to elections and the Brexit process. Furthermore, the upturn has already lasted since 2009.

Given the above factors, we consider it appropriate to maintain a broad portfolio, which means a small overweighting of equities and an underweighting of fixed income investments where we prioritise investing in corporate credits with relatively short maturities. In alternative investments, we maintain a broad diversification among various hedge fund strategies.

OUR PORTFOLIO MANAGEMENT – ASSET ALLOCATION

- Somewhat higher risk than a neutral situation after signals of stronger economic performance, with slight overweighting of equities and alternative investments and underweighting of fixed income investments.
- Positive forces: Central banks, relative valuations, expected 12-month returns and potential increases in economic growth rates.
- Negative forces: Global debt, absolute valuations, key rate hikes in the US and a period of strong performance behind us, as well as the risk of greater protectionism.

GLOBAL EQUITIES

- Earnings will increase about 10 per cent in 2017.
- Valuations: Price/earnings ratio of 16 based on 12-month forward estimates.
- We prioritise stock markets that will benefit from higher global growth and a strong USD, such as Europe and Japan. This will also eventually benefit emerging market (EM) equities, but political threats are creating short-term risks.
- Value shares should perform better than growth shares.

NORDIC EQUITIES

- We expect the best earnings growth for seven years.
- After several years of expanding multiples, we expect an earnings-driven stock market rally in 2017.
- Increased inflation pressure may mean less monetary policy support ahead.
- Investors expect a low risk of a trade war; we believe this is correct – if not, our positive stock market scenario will come to nought.

FIXED INCOME INVESTMENT

- Swedish inflation close to target – the beginning of the end of Riksbank stimulus measures.
- The European Central Bank will continue to stimulate the market but will reduce the size of its securities purchases.
- The US Federal Reserve (Fed) will gradually speed up its tightening.
- Corporate credits with relatively short durations are our base holdings early in 2017.

ALTERNATIVE INVESTMENTS

- Stronger growth rate, rising inflation and increasing corporate earnings will generate strong trends and good conditions for hedge funds.
- Differences between sectors and regions will create opportunities for relative positions.
- Event-driven hedge funds will enjoy a continued good environment, since we expect high corporate transaction activity.
- We continue to advocate broad exposure among different strategies.

Market view – macro

Surge in economic indicators defies political turbulence

We are now seeing signals that last autumn's upturn in various sentiment indicators is about to be transformed into better economic growth. The upturn is occurring in a number of countries. We are adjusting our growth forecasts for both the euro zone and China, but the upturn is most pronounced in the United States. Aside from expectations of more growth-promoting policies, the acceleration is being driven by several factors. The oil price recovery has stabilised portions of the financial markets and eased pressure on producer countries. Meanwhile prices are low enough to help sustain growth in net oil importing countries. We are also now seeing resource utilisation rising to levels that will trigger an increase in capital spending and generate some wage inflation, especially in the US. Fears of a recession and/or deflation can now be removed from the hazard list, which in itself is contributing to a more positive mood. Partly due to the generally brighter outlook, households will probably shift from increased savings to somewhat higher consumption. Private consumption is still driving global growth.

One lesson of last year's political turmoil is that we economists tend to exaggerate the impact of political events on economic trends, especially in the short term. Yet politics poses the biggest main near-term risk. Europe's political challenges – the Brexit process as well as increased nationalism and anti-EU sentiment – may create turbulence. Yet perhaps the clearest threat is from political currents in the US, where the Trump administration may end up in serious conflicts both with other key players in America and with other countries. A major trade conflict would undoubtedly risk harming the economic growth outlook.

In addition to political risks, demographic headwinds, structural imbalances and record-high debt will affect the world economy. Although the outlook is becoming unmistakably brighter, all these factors pull down potential growth. Our upward adjustments in the growth forecast are thus relatively small.

US – Robust growth, messy politics

The mood has improved on a broad front, both among households and businesses. This began even before the November election but accelerated along with rising expectations of fiscal stimulus. We are making a clear upward revision in our US growth forecasts, partly driven by the stimulus from expected tax cuts, but the total contribution of fiscal policy will be limited, given the large cuts in public spending that have been announced. Stronger growth will also be driven by capital spending, especially in the energy sector, which will benefit from policy changes as well as stable oil prices and the prospect of rising private consumption. Households, which account for most of GDP, will benefit from tax cuts and a continued strong job market. However, this has not yet had an impact on consumption. After prioritising their savings for several years, we now expect households to use a larger portion of their income gains for consumption.

Euro zone – Economies defying politics

We see clear signs that growth has accelerated in recent months. Not only are various sentiment indicators at their highest since 2011, but rising employment and low interest rates are also benefiting households, while the export outlook has improved. This will lead to broad-based growth, which is also reflected in rising business investments and optimism. We have thus revised our GDP forecast a bit higher.

In 2017, news headlines will continue to be dominated by political events. But the focus will shift to the euro zone,

US COMPANIES CLEARLY MORE OPTIMISTIC

Source: National Federation of Independent Business, Institute of Supply Management

Business optimism rebounded in 2016 and got a real boost after the election. This was especially true of small businesses, which had previously lagged behind. One explanation may be that due to their limited opportunities for tax planning, they will benefit more from proposed tax cuts than large corporations.

where a number of countries will hold elections this year, including the Netherlands in March, France in April-June and Germany in September. Now that major English-speaking countries have so clearly turned their attention inward, with greater emphasis on national interests, political conditions are also changing in the euro zone. Opposition to federalism is found not only among populist forces; making more room for national solutions within the framework of the EU project enjoys broad public support. This magnifies uncertainty about the EU's future direction, but we do not anticipate that election outcomes will have any major impact on the euro zone economies in the short term.

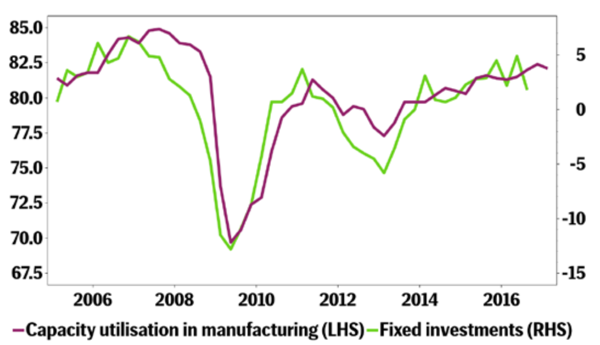
Japan – Sluggish growth amid headwinds

Demographic headwinds and structural problems continue to hamper Japan's growth. Large fiscal stimulus packages and powerful monetary policy by the Bank of Japan are providing support – along with better global growth and an undervalued yen. Given the country's major underlying problems, growth is only a bit above zero, even though companies – especially exporters – are clearly benefiting from global growth and the yen exchange rate.

EM sphere – Brighter outlook despite Trump

The emerging market (EM) sphere, especially the BRIC countries (Brazil, Russia, India and China), are facing many pressures. Several of President Trump's declarations are connected to relations between the US and EM economies, especially in terms of trade policy. Meanwhile, a big upturn in US interest rates and/or major dollar appreciation may have a sizeable negative impact on the EM sphere, especially by triggering capital outflows. Yet we expect faster aggregate EM growth in 2017-2018. Accelerating global growth, more stable commodity prices and continued low international interest rates will help sustain most EM economies. Trump has also indicated that he will negotiate, which suggests that the worst fears need not come true.

HIGHER EURO ZONE CAPITAL SPENDING EXPECTED



Source: Eurostat, Macrobond

Despite a partial recovery in recent years, capital spending is still about 10 per cent lower than in 2008. Several factors suggest that investments will continue to increase ahead. Capacity utilisation in manufacturing is above its historical average, the European Central Bank's expansionary monetary policy is also helping, while housing investments are rising.

The Indian economy is being hampered in the short term by the sub-optimal way that the government implemented its important currency reform, creating sizeable liquidity problems. But the underlying strength of the economy remains. A number of key reforms have been implemented, for example related to competition law. In both Brazil and Russia, the recession is over, mainly due to stabilised commodity prices. New political risks related to corruption scandals have emerged in Brazil and there are continued major structural problems in Russia, but we expect modest growth ahead.

China – Controlled slowdown under way

China's controlled deceleration will continue. In 2016 the authorities achieved their growth target thanks to continued credit expansion, but this increases risks in the economy, so last autumn they began a cautious credit tightening. Much of the country's political leadership is likely to be replaced during next autumn's planned reshuffle. We thus expect top leaders in Beijing to avoid actions and reforms that jeopardise growth and employment. Fiscal stimulus may also be employed to sustain growth. Heavy industry is likely to show continued weak growth as the authorities try to rebalance the economy away from capital- and credit-intensive sectors. The service sector, which accounts for more than half of the economy, has held up well while manufacturers have faced headwinds. Services will probably continue to drive growth. One major risk is trade and security policy relations with the US. The next few months will probably show how they may affect China's economic outlook.

Sweden – Upturn in domestic demand

Swedish economic indicators have also improved in recent months. Although our growth forecast was already higher than that of many others, we are choosing to adjust it slightly upward. This change is partly due to stronger exports, but domestic drivers still dominate. This includes very rapid expansion in housing construction and public sector consumption.

Fiscal policy will remain expansionary in 2017-2018, mainly due to rising public sector consumption in the wake of the large refugee flows of recent years. Stronger international economic conditions, combined with a weak krona, have boosted manufacturing sentiment indicators to five-year highs. Hard data like industrial production and merchandise exports have been more mixed so far, but there are many indications of acceleration in the coming months. Household consumption increased somewhat more slowly than expected in 2016. This is probably due to worries about a future home price decline and low confidence in Sweden's economic future. But late in 2016, consumer confidence rose clearly, suggesting that consumption may accelerate this year.

Nordics ex Sweden
– Divergent, but brighter prospects

Norway's "mainland" economy (excluding offshore oil and gas) is continuing the recovery that began about a year ago, but the energy sector is still holding back growth via falling capital spending to a greater extent than we had previously expected. Inflation is subdued, which will postpone expected key interest rate hikes.

The Finnish economy has finally accelerated, leaving stagnation behind. Industrial production rose in 2016 for the first time in years, and the order situation has improved. Households are an important growth engine, and confidence has climbed noticeably.

In Denmark, a major upward revision in the national accounts for 2014 and 2015 has resulted in data more in line with other indicators. The obviously good growth during these years looks set to persist, but household consumption slowed during early 2017, among other things due to tighter credit restrictions. Exports and to some extent capital spending will accelerate and take over as growth drivers.

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

- Higher economic growth and rising inflation are providing good hopes for corporate earnings.
- Consumers remain in the driver's seat, but capital spending may contribute more to growth.
- Central bank stimulus programmes may begin to be dismantled, in itself a sign of health.
- The economic outlook described above underscores the risk of future long-term yield upturns, squeezing valuations in the fixed income market.
- Fiscal stimulus is likely to support growth and may shift the focus of markets and drive sector rotation...
- ... and the same is true of political steps in the US to help the energy and financial sectors.
- More stable EM growth, but bigger short-term political risks because of Trump's signals.
- The recent upturn in risk appetite will make the market more sensitive to reversals.
- Underlying obstacles to growth remain in place; it is important to maintain reasonable expectations.

GBP – YEAR -ON-YEAR PERCENTAGE CHANGE	2015	2016 (F)	2017 (F)	2018 (F)
United States	2.6	1.6	2.6	2.6
Japan	1.2	0.9	0.6	0.5
Germany	1.8	1.9	1.8	1.8
China	6.9	6.7	6.6	6.2
United Kingdom	2.2	2.2	1.1	1.2
Euro zone	2.0	1.8	1.8	1.9
Nordic countries	2.3	2.2	2.1	2.1
Sweden	4.1	3.7	3.1	2.4
Baltic countries	2.0	1.8	2.7	3.1
OECD	2.4	1.8	2.1	2.2
Emerging markets	4.1	4.0	4.8	4.9
The world (PPP)*	3.3	3.0	3.6	3.7

Source: SEB, OECD

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

Global equities

Optimism and higher growth fuel hopes of better earnings

After a very bumpy ride during the first half of 2016, the year ended on a positive note. Robust macroeconomic data, rising interest rates and yields and the strong dollar overshadowed the political threats posed by Brexit and the US presidential election. Donald Trump's victory was interpreted favourably by the market. Increased infrastructure investments, reduced regulation and tax cuts will probably be implemented, while market players are less convinced that protectionist policies will be implemented to the extent promised. There is great uncertainty about Trump's policies, but our perception is that they will contribute to higher growth, higher interest rates and a strong dollar.

- We prioritise stock markets in regions that will benefit from higher global growth and a strong US dollar, such as Europe and Japan.
- Value shares should perform better than growth shares.
- A synchronised global economic recovery suggests that earnings forecasts will be realised this year.

THE CORPORATE REPORT SEASON HAS BEGUN and we see dawning optimism among corporate executives. US banks were among the first companies to report, and they delivered strong earnings, helped by high activity during the final quarter of 2016. Net interest income improved, thanks to rising interest rates – something we can look forward to, with a certain lag, among European banks. Oil company earnings also improved due to higher prices. Commodity prices in general have climbed, stimulating activity among industrial companies. Activity in the construction sector is also high. We have seen mixed earnings in the consumer sector, with traditional retailers such as US-based Macy's, Nordstrom and Kohl's losing ground to Internet-based "e-tailers". It is increasingly clear that digitisation in the retail sector represents a business risk for many companies, and investments in this area are essential to compete successfully in the future.

Given the synchronised recovery in the world economy, we consider it likely that earnings forecasts will be realised this year. Around 10 per cent earnings growth in 2017 is a reasonable assumption; this is synonymous with a price/earnings (P/E) ratio of more than 16 in 2017.

Value shares versus growth shares

Value shares are traditionally defined as shares with low valuations – in the form of low P/E ratios and low price-to-book (P/B) ratios – and high dividend yields. Value share earnings are closer in time and are thus less interest rate-sensitive than growth share earnings, since most of the latter are further away in time. Value shares are often cyclically sensitive and react strongly to changes in economic growth rates. Growth shares are defined as shares with high expected and historical earnings growth, as well as a history of high turnover rates. As a rule, growth shares are less cyclically sensitive and are often found in sectors with structural growth. Examples of growth shares are Facebook and Amazon.

In earlier issues of *Investment Outlook* we have drawn attention to the positive trend for growth shares compared to value shares since the financial crisis, noting that a reversal in their relative performance would be natural for valuation reasons. Valuations as such are rarely a good short-term indicator, and a trigger is thus needed. This may take the form of good economic statistics, preferably accompanied by rising interest rates and inflation. This positive economic scenario now appears likely to be realised.

As economic statistics improved last autumn, value shares performed significantly better than growth shares. After the US presidential election, value shares soared, while growth companies lost ground. US value companies in the small business segment performed especially strongly, because they would benefit the most from a cut in corporate tax (since they do not have the same potential for tax planning as major international corporations, and they also have higher domestic exposure). US banks were the strongest performing major corporations thanks to the upturn in interest rates, along with hopes of a reduc-

VALUE COMPANIES SURGED AS ECONOMIC DATA IMPROVED

Source: Bloomberg

As economic statistics improved during the autumn of 2016, value shares performed significantly better than growth shares. After the US presidential election, value shares soared while growth companies lost ground. US-based value companies in the small business segment performed especially well.

tion in finance sector regulation. European and Japanese banks also rebounded as interest rates rose. Banks, often categorised as value companies, contributed to the relative strength of value shares.

Valuations of growth companies compared to value companies are clearly higher using traditional indicators, which is natural when the economic growth rate is higher. More interesting is how the indicators have changed since the financial crisis for these two categories. What is clearly apparent is that equity valuations of growth companies are back at their pre-crisis level, while valuations of value companies are 30 per cent lower. This can be partly explained by lower valuations of banks, whose profitability was halved during the period. A further explanation is that investors have taken refuge in shares that are not dependent on the economic cycle, after a long period of low economic growth. We are now seeing tendencies for these flows to reverse (see chart). If the economy improves further, which we believe it will, traditional companies will be helped by this to a greater extent than growth companies, due to higher operational leveraging (a higher fixed cost base and lower margins). Rising interest rates are an indication of better times, which tend to coincide with a better period for value shares.

Regional overweight in Europe and Japan, underweight in the US and emerging market (EM) shares

We prefer Europe and Japan as regions for overweighting in a global equity portfolio, since we are optimistic about the economy. Europe (excluding the United Kingdom and Switzerland) and Japan have higher leveraging than the US, which we choose to underweight. We are optimistic about the EM sphere in the long term, but at present we see the new US administration leaning in a protectionist direction, which would adversely affect EM countries. The US policies unveiled so far should also result in a strong dollar, which would have a negative impact on relative stock market performance in EM countries while it would be positive for European and Japanese stock exchanges.

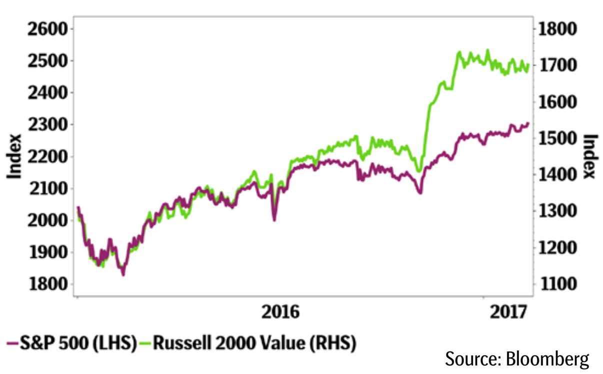
European economies have stabilised, despite political unrest and banking sector problems. Domestic demand is improving thanks to job growth and low interest rates. Businesses are demanding loans, and credit growth is positive. The banking sector still has problems in some countries – such as Italy – but at the aggregate level, balance sheets have strengthened and profitability has stabilised.

The European Central Bank (ECB) is helping to keep interest rates and yields low by means of large bond purchases, which in turn improves corporate earnings and facilitates investments. These bond purchases are also holding down the value of the euro despite the improved economy, providing the export sector with an extra injection. Our assessment is that the earnings of European companies, helped by the economic cycle and exchange rates, will grow faster than those of US companies.

Japan has a highly cyclical stock market with a large element of industrial firms, tech companies and banks with low valuations. Earnings performance is most closely correlated with global industrial production in major stock market countries because of a large cyclical element, a high cost base and relatively low margins. The Japanese currency also plays an important role, since there is a high correlation between the JPY exchange rate and the stock market. If the yen weakens the stock market strengthens, and vice versa. US key interest rate hikes thus benefit the Japanese stock market, since they make the yen relatively cheaper.

The shareholder-friendliness of Japanese listed companies has historically been sub-optimal. This is now changing for the better, partly through the actions of Prime Minister Shinzo Abe. Companies are now being run to a greater extent on the basis of profitability. This has resulted in increased cost-awareness among companies, with a larger percentage of profits being distributed to shareholders through buybacks and dividends. Companies are still too conservative by Western standards, with more than 20 per cent of their market capitalisation in cash, but this should instead be viewed as a potential. Due to changing perceptions of corporate governance, we can also be optimistic about the Japanese stock market in the long term. From a valuation standpoint, the attractiveness of the Japanese stock market lies in its undervalued equity capital, combined with our expectation that the return on equity will improve.

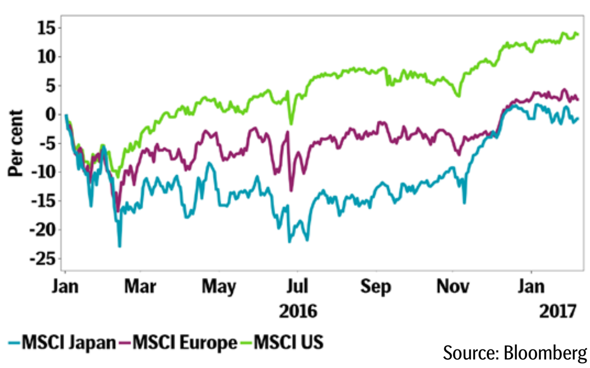
US SMALL BUSINESS SHARES UP SHARPLY AFTER ELECTION



Source: Bloomberg

Investors began increasing the proportion of US small business shares in portfolios last summer when macroeconomic indicators improved. After the presidential election small business shares soared, since they have larger domestic exposure than big companies. Any tax cuts will also benefit smaller firms more, since they have less chances to do tax planning.

BIGGEST POTENTIAL IN EUROPE AND JAPAN



Source: Bloomberg

US stock markets performed well in 2016 and valuations are now relatively high. Our assessment is that earnings of European companies, helped by the economic cycle and exchange rates, will grow faster than those of US companies. We are also optimistic about the Japanese stock market, since among other things it will benefit from upcoming US key interest rate hikes.

Nordic equities

Earnings now on the rise

After several years of a stock market upswing driven by monetary policy, we now foresee the best potential for earnings growth in seven years. Our conviction is supported by both macroeconomic indicators and corporate earnings announcements. Sector rotation from growth companies to value shares is exceptionally strong, and investors who hesitated to follow this trend have lost a lot in relative returns over the past year. We have a positive view of equities and expect a good year for the stock market in 2017, yet we are a bit worried about the clear lack of investor worries. There is considerable economic policy uncertainty, but it seems investors are unprepared for a more negative global trend than in our main scenario and are instead being cheered by positive macro signals.

- We expect the best earnings growth in seven years.
- After years of expanding multiples, an earnings-driven stock market upswing awaits in 2017.
- Increased inflation pressure may mean less support from monetary policy going forward.
- Investors are ignoring the risk of a trade war; we believe they are correct – unless our positive stock market scenario proves wrong.

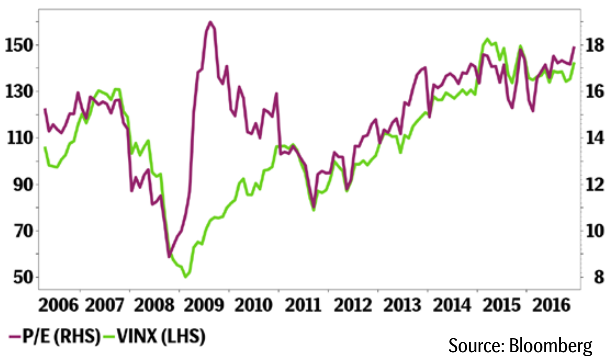
SEB HOLDS ONE OF THE BIGGEST investor seminars in the Nordic countries in January each year. This year, top executives – usually CEOs or CFOs – from 133 Nordic listed companies of various sizes from 11 sectors attended the event. Compared to a year ago, the tone was far more positive, especially from companies with sales in emerging markets or with exposure to commodities and energy. The mood is not jubilant yet but, compared to last year's glum faces, it was a substantial improvement. Combined with the upturns in a number of important leading economic indicators – everything from US manufacturing to Finnish consumer confidence, this reinforces our conviction that earnings growth for Nordic listed companies will be significantly better in 2017 than in the previous couple of years. Recent statistics, especially from China but also from Sweden and the US, show that manufacturers have started to raise prices. Although these price hikes are probably mostly a matter of manufacturers passing on higher commodity and energy costs to their customers, it is hard to ignore the clear correlation between the earnings trend for Nordic listed companies and Chinese producer price inflation observed over the past decade. We see good potential that our forecast of double-digit earnings growth this year – for the first time since 2010 – will be realised. If nothing unforeseen happens to bring the global economic recovery to a standstill, it is highly likely that 2018 will be a good year for corporate earnings, which will be needed for good stock market performance during the second half of this year.

The most significant earnings improvement this year is expected among commodity and energy producers, for example the Finnish steelmaker Outokumpu and the Norwegian energy group Statoil. Swedish companies are not expected to post equally remarkable growth figures, but industrial (capital goods) firms on the Stockholm stock exchange are expected to increase their net earnings overall by nearly 11 billion Swedish kronor to 105 billion kronor in 2017, which makes this the single most important sector in terms of total earnings and earnings growth.

After years of swollen P/E multiples, earnings will take over as stock market driver

Brighter earnings prospects have come at an opportune time. After years of earnings disappointments and continuous downward forecast revisions, many investors had started to question the capability of central bank stimulus to spark economic growth. The only thing that appeared to gather momentum from increasingly extreme measures by the world's central banks was asset prices; interest rates and fixed income yields fell to increasingly astonishing lows, while property prices were described as bubble-like. Equity investors also have the central banks to thank for rising stock market indices in Sweden and the other Nordic countries in recent years. As shown in the chart below, the favourable stock market trend in the Nordics has been driven by increasingly higher valuations (P/E ratios).

LOW INTEREST RATES, MULTIPLE EXPANSION HAVE DRIVEN UPTURN



Source: Bloomberg

The chart shows the VINX benchmark index for Nordic stock markets and the P/E ratio for the consensus forecast. The sharp price fluctuations in 2008-2010 were largely driven by changes in earnings outlooks, but the upturn in recent years has been a function of lower return requirements (higher P/E ratios). The phase-out of various monetary stimulus measures suggests that multiple expansion will not drive a sustained stock market upturn during the coming year.

These higher valuations, in turn, can be explained mostly by expansionary monetary policy. Quantitative easing in Europe and Japan will continue for a while, yet we have probably seen the end of the most expansionary phase of global monetary policy. Now the big questions are when and how various stimulus measures will be phased out – for instance, a tapering of European Central Bank (ECB) bond purchases, plus key US interest rate hikes combined with a shrinking of the Federal Reserve's balance sheet. As a result, falling return requirements will most likely no longer be an important stock market driver over the next year.

In this context, it is also relevant to note signs of increased inflation pressure from China, the "world's factory". All else being equal, Chinese manufacturing price hikes of more than a 5 per cent annualised rate, after five years of deflation, should lead to a decreasing deflation risk in most major economies around the world, and conditions will be less favourable for further monetary stimulus measures. Without new monetary stimulus, it will be a challenge to push up valuation multiples any further.

Equities not cheap but better than the alternative
The stock market could potentially benefit from a further deterioration in the outlook for the main alternative to equities: bonds. With nominal interest rates up only marginally from record lows and with clear signs of a lower deflation risk, there is a high probability that bond investment values will fall in the year ahead. Over the past six months, the OMX Nordic Exchange Stockholm's interest rate (OMRX) index, which tracks the value of a typical portfolio of Swedish government bonds, lost 3.2 per cent in value. The whole idea of an investment in government bonds and other high-quality fixed income assets with low nominal interest rates is that they should not lose value. If the trend over the past six months is sustained, there is a clear risk or chance that capital will be rotated out of bonds and that some of this will instead go into the stock market.

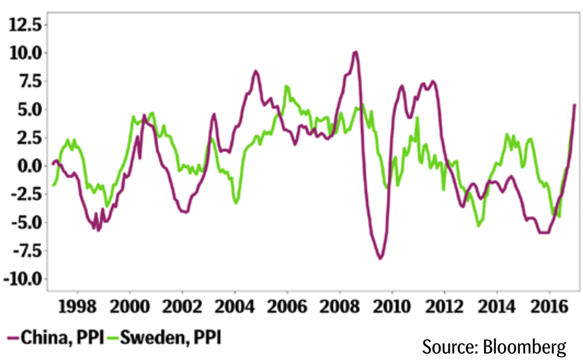
While equities are somewhat more expensive than normal today, valuations are not as historically extreme as for bonds.

A turbulent year
The past year was extreme for the stock market in many ways. After a weak start, with a focus on risks and financial restructuring for commodity producers around the world, a remarkable recovery began in March, with the spotlight on those market players that had been hardest hit.

In Sweden, this trend can be exemplified by SSAB, which was the best performer in the Stockholm OMXS30 index in 2016; the steelmaker's shares more than doubled in value after adjusting for a new share issue. However, the question at the beginning of the year was mainly about whether the principal owner was willing to take part in the company's debt refinancing package, a solution that was considered unavoidable, and how and when this would be announced. Subsequently, a combination of production restrictions in China, protective tariffs and the promise of stimulative US infrastructure investments improved economic conditions for manufacturers. A successful refinancing package, including a new share issue, enabled SSAB's prospects to improve dramatically.

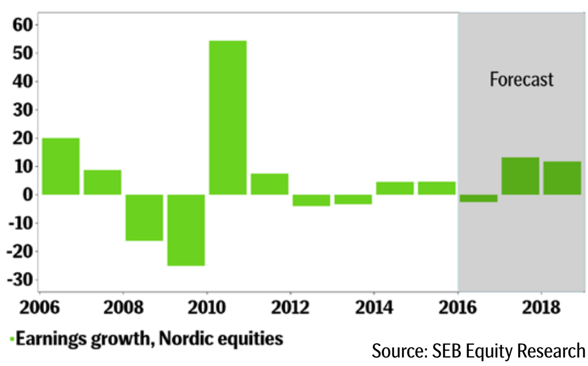
Brighter prospects for cyclical industries also contributed to the most noteworthy sector rotation in the Nordic stock market for eight years. The fact that SSAB now has a higher valuation than the Danish-based health care company Novo Nordisk in consensus forecasts for both 2017 and 2018 is not considered strange at all, but rather a natural consequence of the thematic rotation from growth company shares to so-called value shares. In this same thematic rotation, the valuation premium for security system provider Assa Abloy versus the Stockholm stock exchange was halved to 30 per cent in just one year, whereas Statoil – in our earnings forecast for 2018, assuming oil prices of 60 dollars per barrel – is valued at premiums of 32 (P/E) and 85 per cent (enterprise value/EBIT) compared to the average for the eight-year period 2006-2013 (before oil prices plunged in 2014/2015 and their recovery in 2016 started to change the picture). The momentum of this sector rotation is so great that many professional investors probably believe they cannot afford to remain on the sidelines, which provides further support for this trend.

INCREASED INFLATION PRESSURE IN THE "WORLD'S FACTORY"



The charts shows producer price inflation in China and Sweden. Today China is something of a "world's factory" and after years of falling sales prices in Chinese manufacturing, substantial increases are now occurring. Higher metal and energy prices obviously have an effect on manufacturing costs. While central banks focus on other inflation metrics that exclude energy price fluctuations, it is difficult to dismiss the idea that higher Chinese production costs should have an effect on goods prices around the world.

EARNINGS GROWTH THIS YEAR SET TO BE BEST SINCE 2010



The chart shows annual aggregate earnings growth for Nordic listed companies, calculated in euros and adjusted for non-recurring items. A recent rise in leading indicators and more optimistic corporate earnings announcements bolster the credibility of what appear to be optimistic forecasts for 2017.

At the same time, it is important to emphasise how difficult it is to know how high valuations actually are for what are now the most fashionable cyclical shares among investors. For instance, we raised our 2017 earnings forecast for Outokumpu by 174 per cent within ten months, and if current ferrochrome prices hold for the rest of the year, we will need to make further substantial upward revisions in our forecast.

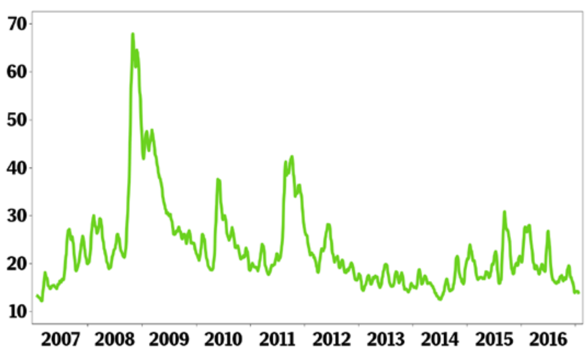
While the recovery in the steel industry, for instance, has been surprisingly strong, a number of "old" growth champions in the Nordic countries have had problems in the past year. Growth at Assa Abloy has been weighed down by a sharply negative trend in China, fashion retailer Hennes & Mauritz (H&M) has had negative same-store sales growth for the past 18 months (roughly -2 per cent on average for the period), and Novo Nordisk has been affected by far heavier price pressure than we, the company's management or the market consensus expected just one year ago. During the same period that we revised our earnings forecast for Outokumpu upward by 174 per cent, we made only modest upward revisions for Assa Abloy, while we lowered our earnings forecast 12 per cent for Novo Nordisk and 21 per cent for H&M. As long as these trends hold, the sector rotation to value shares will continue, although such companies often look more expensive than those with historically good earnings growth in current earnings forecasts.

Worrisome lack of worries despite great uncertainty

The sharp reversal in earnings revision trends noted above and the sector rotation in equities are enough to make the past 12 months a remarkable period, but many people nonetheless probably consider last year's political developments an even greater surprise. Without ranking the above events in terms of surprise level, we believe there was one even more surprising change in 2016 – in investors' attitudes towards political risk.

After reacting forcefully to signs of heightened political risk over the past decade, even when it required rather far-fetched assumptions to see any direct impact on the economy or corporate earnings from these events, investors now appear to be unshakably steadfast in their faith in the stock market.

DESPITE POLITICAL UNCERTAINTY, INVESTORS UNWORRIED



Source: SEB, Bloomberg

The chart shows the three-week moving average of implied (expected) volatility for options in US and European stock market indices (the VIX and Euro Stoxx 50 volatility indices), two traditional indicators of investor worries. Over the past decade, there has been a clear connection between media coverage of political uncertainty and the level of investor worries, but the investor community is now apparently convinced that everything will go well.

An international trade war driven by the US is one of the worst economic threat scenarios we have seen for a decade, and hopefully such talk will remain just rhetoric. We expect this, as do investors apparently, judging from the volatility index (which reflects the level of investor worries – the more worries, the higher the index). However, it is fascinating that the same investors who listened intently to the Greek finance minister's every word a couple of years ago in making their investment decisions today seem to view the US president's protectionist statements with as much interest as a rerun of *The Apprentice* starring Donald Trump. It seems as if the risks related to the coming Brexit negotiations and the euro project in general are now being ignored, even though the refugee crisis of recent years and recurring ISIS terrorist attacks have further fuelled anti-EU forces – something that would have had a clearly unfavourable effect on the stock market a few years ago.

One index based on a frequency count of words about economic uncertainty in a number of US news publications, not surprisingly, shows a clear correlation with indices of financial market turbulence (measured as implied volatility) over the past decade, but last year that relationship was completely upended. Newspaper articles about various aspects of economic policy uncertainty are near a record high, but implied volatility is near a historical low.

Anyone who had received prior knowledge in early 2016 that British voters would decide to leave the EU and Trump would win the US presidential election on promises of trade barriers against China and Mexico would probably have thought that speculating on increased investor anxiety was a nearly risk-free investment, but the VIX volatility index has fallen by half in the past year. Another classic investment that tends to rise in value when there is growing financial market anxiety is gold. Although gold prices have risen more than 8 per cent in USD in one year, during the past seven months – when both Brexit supporters and Trump won unexpected victories – gold prices have instead fallen a bit. There is clearly very limited interest in this type of "insurance" against financial market turbulence today.

We have a positive view of the stock market in 2017, driven by improved economic conditions and earnings growth, but it is worrisome that worry indicators such as the VIX volatility index are at such low levels. That indicates poor preparedness for any downside surprises.

% Fixed income investments

Loose central bank policies nearing their end

With expectations of stronger growth and rising inflation, market interest rates and yields have started to climb, while central banks are focused on dismantling instead of expanding their respective stimulus programmes. To counter this reduction in monetary stimulus, fiscal policy will instead play a greater part on the world stage, with Donald Trump in the lead role.

- Inflation close to target – beginning of the end for the Riksbank's experiment.
- The ECB will continue to stimulate the market but is reducing the size of its purchases.
- The Fed will gradually accelerate its monetary tightening pace.

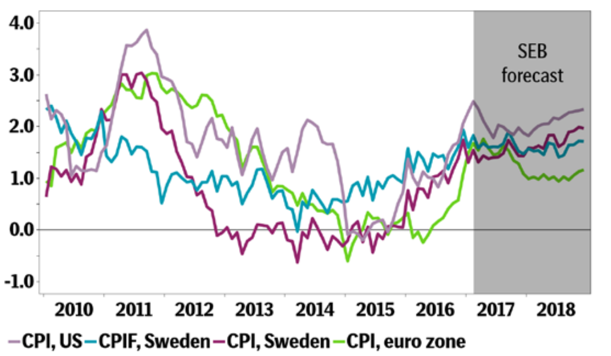
Government bonds (excl emerging markets)

Sweden's Riksbank left its benchmark repo rate unchanged in December at -0.50 per cent and extended its bond purchases through the first half of 2017 at a rate of 30 billion Swedish kronor a month. However, its Executive Board is still prepared to introduce more expansionary monetary policy if the upward inflation trend is threatened. The Board was divided about whether to make policy even more expansionary (extend bond purchases), with half the members dissenting from this decision. Earlier weakness in the Swedish krona, together with higher electricity and food prices, pushed Swedish inflation up to nearly 2 per cent, but unfortunately both the Riksbank's and our own forecasts indicate that the good news will be short-lived. We expect inflation to fall again this year to around 1.6 per cent by the end of 2017. Our previous forecast that the next rate hike will be in December 2017 still holds, whereas the central bank's own forecast is that repo rate hikes will begin during the first half of 2018 at the earliest. Although inflation will be below the Riksbank's 2 per cent target at year-end 2017, we believe that inflation close to target will be sufficient for a December rate hike, which would make it easier for the Riksbank to take a step back from its aggressive easing of recent years. As a result, the upturn in Swedish long-term yields should continue gradually, in line with a less expansionary monetary policy.

The European Central Bank (ECB) decided in December to extend its bond-purchasing period by nine months, to the end of 2017, but at the same time it reduced monthly bond purchases from 80 to 60 billion euros beginning in April. Now that inflation is finally above zero and the growth picture is somewhat brighter, the pressure for ECB stimulus has eased somewhat. On the other hand, countries still struggling with large public debts and political problems will continue to need very loose monetary policy. We believe the ECB will keep its key interest rate unchanged but will decide in September to further extend its bond purchases, in part to reduce the risk of volatility caused by political factors. Such an extension will also probably be accompanied by another decrease in the size of its purchases.

As expected, the US Federal Reserve (Fed) raised its key interest rate in December by 0.25 points to a range of 0.50-0.75 per cent while also revising its interest rate projections upward for the next couple of years. The Fed now forecasts three rate hikes yearly in 2017 and 2018, which is more than it predicted in September last year. The central bank explained that the December rate hike was due to strong economic growth and accelerating inflation. A majority of the members of its Federal Open Market Committee expressed uncertainty about fiscal policy, since they see upside growth risks. We are sticking to our forecast of two rate hikes in 2017, which is in line with market pricing, but we now believe there will be three hikes in 2018. As a result, our forecast is to expect a key rate of around 1.75–2.00 per cent at the end of 2018. Meanwhile we believe that the Fed will start unwinding its bond holdings. The reason we have fewer rate hikes in our forecast for 2017 compared to the Fed's forecast is that we expect tightening effects from higher long-term yields and a stronger dollar. The rise in bond yields came to a halt in early 2017, but we believe

RISING BUT LOW INFLATION



Source: Riksbank, SEB

Inflation has continued to rise in recent months, and the era of zero inflation is apparently over in most countries. The increase in total inflation is mostly a result of higher oil prices but also rising food prices, plus – in Sweden – the effects of a weaker krona last autumn. However, we expect inflation to fall again during the next several quarters.

this is a temporary pause and that yields will continue to climb in an environment where both growth and inflation are rising. Furthermore, the relationship between supply and demand will change as the Fed starts shrinking its bond portfolio and more expansionary fiscal policy leads to somewhat larger US Treasury securities issues.

The Bank of Japan left its monetary policy unchanged in December and thus continues its quantitative easing, which is aimed at keeping 10-year bond yields at around zero. The central bank's interest rate announcement exuded a good deal of optimism given the weak yen, leading to an upward revision in growth prospects.

Emerging market debt

Emerging market (EM) economies are now being challenged by US protectionist signals, higher yields and interest rates around the world and a strong dollar, which are causing capital outflows to the US.

For countries that President Trump has identified as targets, the market effects have been especially pronounced. Among EM economies, India continues to grow at the fastest pace while commodity-producing countries are benefiting from higher, more stable commodity prices. EM interest rates and yields are generally much higher than their US counterparts, both in USD and local currencies. In the choice between investments denominated in USD and local currencies, we see an advantage in USD, but investments in local currencies may be selectively attractive in countries where monetary stimulus measures are likely to be implemented. Commodity producers that generate high returns should have an advantage over exporters of manufactured goods, since they enjoy support from rising commodity prices and inflation, whereas export manufacturers are hurt by protectionist rhetoric.

Corporate bonds – Investment grade and high yield

Conditions in the corporate bond market show comparatively large variations at present, depending on geographic location and rating category. One common factor in the market is that the default rate has turned downward somewhat and, according to Moody's credit rating agency, is expected to fall from a peak of around 5 per cent last year to 3 per cent at year-end 2017. Investment grade (IG) bonds continue to benefit from central bank bond purchases, a factor that should fade over time, however, as bond purchases are phased out. There is great sensitivity to rising yields and interest rates in this segment, which is why the US has an advantage over Europe. US yields and interest rates have normalised much more, with bonds trading at far higher absolute yields than their European counterparts.

In the high yield (HY) segment, there are much greater similarities between the US and European markets. This type of bond is not as sensitive to changes in yields as IG bonds. On the other hand, there is a strong connection to the financial condition of companies in terms of gearing and defaults. Gearing looks set to fall somewhat in 2017 due to improved corporate earnings, while the default rate should fall. Despite a strong 2016 performance, with narrowing yield spreads against government securities, the risk/return relation still looks attractive in the HY segment during 2017.

ASSET TYPE	WEIGHT	TACTICAL EXPECTED YEARLY RETURN			RISK		
		SEK	EUR	USD	SEK	EUR	USD
Cash	**1** 2 3 4 5 6 7	-0.9%	-0.7%	0.8%	0.2%	0.2%	0.2%
Government bonds	**1** 2 3 4 5 6 7	-1.5%	-0.7%	0.3%	2.9%	2.9%	2.7%
Investment grade (IG) corporate bonds	1 2 **3** 4 5 6 7	1.2%	1.3%	2.2%	3.2%	3.2%	3.2%
High yield (HY) corporate bonds	1 2 3 4 **5** 6 7	3.1%	3.2%	3.8%	5.2%	5.2%	5.2%
Emerging market debt*	1 2 3 **4** 5 6 7	4.8%	4.8%	4.8%	13.0%	13.0%	13.0%

"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
** Returns in local currencies.*

Source: SEB

% Theme – Fixed income investments

Corporate credit market opportunities

The current environment, with ultra-low yields, makes it difficult to generate returns on fixed income assets. There are also many indications that yields will remain low for a lengthy period. To find good investment opportunities in this environment, investors need to take risks, both interest rate risk and credit risk. In some cases, they also need to be prepared to forgo liquidity, through investments with longer lock-ins. Below we discuss several segments that we believe offer good potential for attractive value growth.

After many years of falling yields and interest rates, we have a situation today where they are at historical lows. A number of factors explain this trend, with one important factor being demographic changes in the West. An ageing population is saving more, while people's willingness to invest and consume is not growing to the same extent. This is putting pressure on yields and interest rates. Meanwhile lower investment and consumption are holding back inflation. Another reason for these low yields and interest rates is globalisation and the resulting competitive pressure.

Tougher competition means companies have difficulty raising prices at the same pace as before, which also holds back inflation. In this environment, central banks are forced to pursue an expansionary monetary policy to achieve their respective inflation targets. It turns out that stoking inflation is difficult, and there are often large lag effects from monetary stimulus measures that are difficult to predict. We therefore cannot rule out yields and interest rates in Sweden and other countries remaining low for a long while.

Investment opportunities

Traditional fixed income instruments, such as most government bonds, generate low or even negative returns nowadays. Meanwhile, an upswing in market yields and interest rates would further reduce returns. For that reason, investors are starting to take a look at other kinds of fixed income investments that are partly affected by other factors. Flexibility, in order to actively adjust both their interest rate and credit risk, appears to be increasingly important. Below we consider three sources of return in the fixed income market – taking on interest rate risk, increasing credit risk and sacrificing liquidity. We also look at potential investments in these areas.

Taking on interest rate risk – but mitigating it

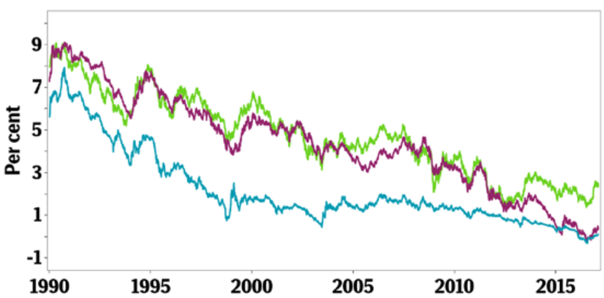
Interest rate risk is the risk that interest rates will rise while you hold a fixed income instrument, since there is a negative correlation between interest rate/yield movements and bond prices. Therefore, the option of assuming interest rate risk has worked well when interest rates and yields have fallen, but with upward movement in market interest rates – which is now the case – conditions are worse for the fixed income market in general and for fixed income instruments with long maturities in particular. When maturities are short, rising long-term yields have only a marginal effect. However, interest rate risk can be mitigated through derivatives or by holding a large proportion of so-called floating rates notes (FRN) in your portfolio. These notes have a variable coupon, which is normally reset every three months, which means interest rate risk is low, since the coupon is continually readjusted. When adjusted, the coupon is set at a money market reference rate (Stibor for Swedish instruments) plus a fixed credit spread or premium.

FRNs are thus only affected by short-term market interest rates and the credit premium. The result is that investors pay the credit premium but are protected on a continuous basis against rising long-term yields. A rise in short-term market interest rates is instead good for FRNs since total return gradually increases. With interest rate derivatives, investors can change the terms from floating to fixed or vice versa.

Increasing credit risk

For investors who can accept higher credit risk, there are several segments that we think offer attractive value growth at present – parts of the high yield (HY) market, subordinated bonds issued by banks, subordinated bonds issued by insurance companies and hybrid bonds issued by large-cap companies.

SEARCH FOR YIELD IS DIFFICULT IN TODAY'S ENVIRONMENT



Source: Macrobond

The chart shows the trend for 10-year government bonds in Japan, Germany and the US, which has been downward over the past 25 years. With historically low yields, the challenge is to find attractive fixed income investments, and that requires more flexible thinking to generate satisfactory returns.

Credit risk is the risk that the company an investor lends money to via the security cannot pay interest or repay the loan (in other words, the company defaults). Over the past 20 years, investors in the HY market have become an important funding source for a large number of companies with lower credit ratings than firms with higher credit ratings, known as investment grade (IG). The yield spread between an HY bond and a 10-year government bond in the same currency is usually called the high yield spread. If there is thought to be a growing risk for HY companies, this HY spread will increase since HY investors will require higher yields to offset the higher risk. Conversely, a lower risk for HY companies will cause the same spread to narrow.

High yield bonds were one of the fixed income market segments with the best absolute returns in 2016, although we still see scope for a continued narrowing of the spread in parts of the HY market. HY companies include both well-known large cap companies and small, fast-growing businesses. The breadth of this market allows fund managers to build portfolios to meet different investor needs for return and risk. Historically, the default rate in the HY market has been 4-5 per cent annually, but this rate varies substantially over time and by sector. The US HY market has a relatively large proportion of energy companies, which had difficulties related to low oil prices early last year. However, rising commodity prices have stabilised the acute situation that had emerged in parts of this market. Thorough analysis and a good risk spread for HY investments will improve the likelihood of achieving the desired risk-return profile.

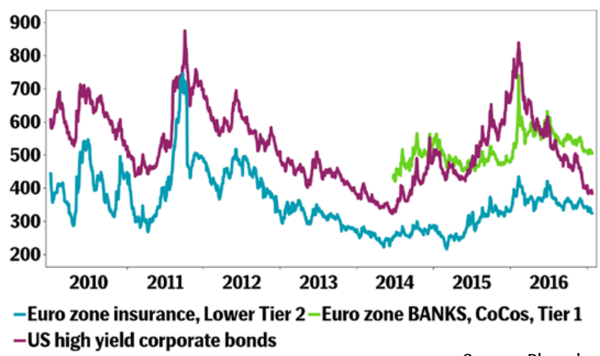
We also consider subordinated bonds issued by banks and insurance companies to be attractive investment opportunities in today's yield environment. If investors study fixed income funds that have a free investment mandate, they are likely to find these segments included in such funds.

These funds may provide unique investment opportunities since, under current regulations, individuals for instance in Sweden cannot invest directly in subordinated bonds issued by banks, so-called contingent convertibles (CoCos). Banks issue CoCos to strengthen their capital base. A bank's capital structure is composed of Core Tier 1 capital, which consists of retained earnings and share capital, as well as a number of buffers that can be used if the bank is unable to pay its debts. These buffers are aimed at increasing the stability of the banking system, and capital from CoCos serves as a cornerstone here.

What makes CoCos unique is that, if a bank's capital adequacy ratio falls below a predetermined level, the bond can be converted in full or in part into equity or the nominal amount is written down. It is important to remember that these instruments are only converted if the bank is in a severe crisis. In pricing a CoCo, an investor should mainly be compensated for the risk that the bond will be converted into equity, the nominal amount will be completely written down or the investor will lose the coupon (interest) and the nominal value for a period of time. Investors should also take into account that this type of bond has lower priority than other bonds if there is a default or corporate restructuring.

The same is true of subordinated bonds issued by insurance companies. CoCos generate high yields, and we believe investors will be compensated for the risks. Interest rates and yields are on the rise, mostly in the US. Normally – given interest rate risk – higher interest rates and yields are not good for bond investments. However, the situation is not clear-cut for bank bonds. A bank's ability to earn money depends on its net interest income: the difference between the interest rate it pays and the interest rate at which it lends to consumers and companies. The low-interest-rate environment has pushed down banks' net interest incomes and thus their earnings. Higher interest rates going forward will probably benefit banks' ability to gener-

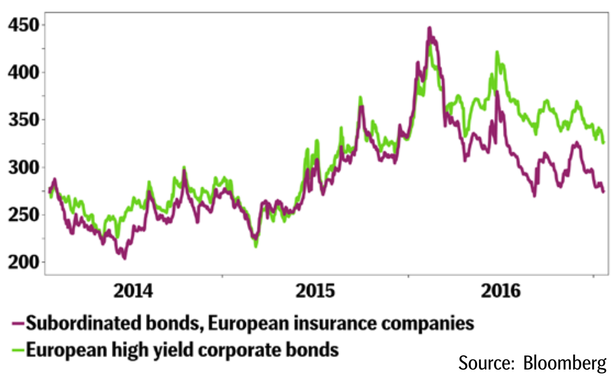
STILL OPPORTUNITIES IN THE CREDIT MARKET



Source: Bloomberg

CoCo yields are high, and we believe investors will be compensated for the risks. The yield spread between high yield and government bonds has narrowed lately, and we still see investment opportunities in parts of the HY market. Opportunities may be found with individual bond issuers or in entire sectors.

ATTRACTIVE SPREADS FOR SUBORDINATED BONDS



Source: Bloomberg

Subordinated bonds issued by European insurance companies generate a higher return than European corporate bonds with a BB credit rating, although these insurance companies have a higher average rating (BBB). The chart shows the yield (credit) spreads compared to government bonds. If the yield spread narrows, prices on insurance companies' subordinated bonds will perform well.

ate earnings and indirectly benefit CoCos. Credit losses in most European countries are back to very low levels; even in Spain and Ireland, the trend is clearly positive. Capitalisation today is far higher than before the financial crisis, while bank capital requirements have increased.

We also believe subordinated bonds issued by insurance companies, which have not followed the trend of narrowing credit spreads, are an attractive investment opportunity. Just like banks, insurance companies issue subordinated bonds to meet capital requirements that have been set to protect policy-holders. Insurance companies are often lumped together with banks, even though they work in a different business and diverge from banks in many respects. Insurance companies collect money in advance from their customers, while payments on insurance claims are made in the future. Insurance companies are thus not as dependent as banks on funding, and defaults are unusual in the insurance industry. Weak companies are normally taken over by stronger companies. Unlike CoCos, subordinated bonds issued by insurance companies cannot be converted into equity or written down. However, coupon payments can be deferred if the company's equity capital falls below capital adequacy requirements, but all coupon payments must be made once the company's capital again meets requirements. Subordinated bonds issued by insurance companies, like CoCos, have lower priority than other bonds in a corporate restructuring or bankruptcy.

Another alternative in the search for yield is hybrid bonds. These bonds are usually issued by stable large-cap companies to strengthen their balance sheet and at the same time improve their credit rating. This is achieved because hybrid capital is often viewed as half equity, half liability. Hybrid bonds are either perpetual or issued with a very long maturity date. Such long duration bonds are expected to be redeemed prior to maturity since, in most cases, only some of the capital generated by the bond issue can be recognised as equity in the initial years; consequently, they are not as attractive a solution for the company after that. The issuer can choose not to pay the coupon but is then required to suspend dividends to shareholders as well. Hybrid bonds are usually issued by stable large-cap companies, with Swedish examples being the automaker Volvo and the power utility Vattenfall.

Sacrificing liquidity

Sacrificing liquidity is another alternative for generating returns in today's low-yield environment.

Investors can often quickly sell securities to generate liquid funds, thus reducing investment risk. But some securities and other types of investment require locking in capital for lengthy periods, due to limited liquidity in their underlying markets.

Liquidity risk is thus indirectly higher for such an investment, but investors receive a higher return as compensation than if the product had daily liquidity. Fixed income funds with limited liquidity are being developed to offer attractive investments in securities which in themselves have limited liquidity and which it is often difficult or not possible for private individuals to invest in.

Limited alternatives for attractive fixed income investments

The investment options above are paths that an investor can take to generate what we regard as good risk-adjusted returns. Fixed income funds that cover all these investment options not only enable investors to gain exposure that is difficult to come by; they also spread the risks between different strategies, which is crucial in making this kind of investment.

Alternative investments

Strong start to the year after challenges during 2016

Due to ultra-low yields and abrupt rotations in most asset markets, 2016 was a challenging year for hedge funds. However, the year ended with a stronger trend due to improved growth prospects following the US presidential election and Donald Trump's pledges of fiscal stimulus measures and an improved corporate climate. This year picked up where 2016 left off, and most hedge fund strategies started 2017 with a far stronger performance than we saw during most of last year.

- Strong end to 2016 after earlier challenges.
- Trump's policy plans have created improved conditions.
- Event-driven strategies did a good job navigating through 2016.

Hedge funds – New US leadership is providing support

It still remains to be seen whether future US policy will actually result in all the positive effects on the real economy already priced in to some extent. But the fact is that market interest rates and yields continue to rise, economic growth prospects have been upgraded and companies are predicted to have better earnings growth potential than for years. While underlying movements in most asset markets are positive in themselves, clearer differences are also being generated between and within various asset classes. This indirectly paves the way for new and clearer investment opportunities for hedge funds. In 2016, large parts of the market tended to move in unison in a low-interest-rate world never seen before. Perhaps higher interest rates and yield as well as lower correlations are the conditions needed for hedge funds to meet their return targets in 2017.

Equity long/short

The favourable performance of major stock exchanges following the US presidential election has benefited equity long/short strategies. Since Donald Trump's inauguration, the difference between sectors and styles has increased. Combined with the underlying strength of the stock market, this creates good potential for fund managers to identify investment alternatives.

Because of the trend in recent months, strategies with a net exposure to equities in a normal market have benefited, although market-neutral strategies also have good potential in a sustained strong market given the above reasoning.

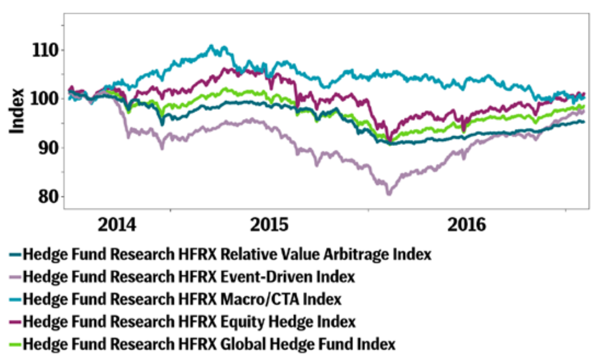
Credit long/short

After a difficult start to 2016 as a result of declining oil prices, the credit market gradually recovered during the rest of the year as commodity prices rebounded. For two months, oil traded above USD 50/barrel, which caused the number of company insolvencies that had been forecast to begin falling by year-end. If the predicted volume of corporate activity is realised and oil prices remain fairly flat, there should be potential for a positive, more stable trend during the year.

Event-driven

This strategy was the brightest star in the hedge fund firmament last year. Spurred by a stronger stock market, a recovery in energy sector corporate bonds and a continued high level of activity in the corporate deals market, this was the best possible environment for event-driven fund managers. Posting the same returns is too much to ask for, but given the strong start to 2017 as well as positive forecasts for global growth and corporate deals, there are high hopes of good performance for this strategy.

2016 – MANY SEGMENTS SUBDUED, BUT MARKET ENDS HIGHER



Source: Bloomberg

After plunging oil prices early last year and market turbulence related to the Brexit referendum, hedge funds finished the year higher. The US presidential election and the subsequent strength of most asset classes contributed to good performance late in the year.

Macro/CTA
Macro funds with a focus on government bonds and currencies belong to the category of hedge funds in which movements in underlying markets have provided good investment potential. We are positive towards this strategy and foresee nothing that will change this picture at present. Meanwhile the correlation with equities and credits remains low. CTAs had a difficult time handling the abrupt changes in underlying trends in 2016. A more predictable 2017 would provide a favourable environment for this strategy.

Commodities – Oil prices have stabilised

Crude oil prices rose sharply following an agreement between the Organisation of the Petroleum Exporting Countries (OPEC) and other oil-producing countries in November to cut production. As a result of the agreement, which went into effect on January 1, 2017, and is in effect for six months, production was cut by 1.2 million barrels to 32.5 million barrels a day. One country, Iran, was granted permission to boost output, which was apparently a condition for reaching an agreement. Russia also signed the pact and has promised to reduce production by up to 300,000 barrels a day. This is the first time in eight years that OPEC has agreed on supply cuts, and the agreement seems to be working so far. There have been reports from major oil-producing countries Saudi Arabia and Russia that they have begun to cut their output. Saudi Arabia has even reduced its production to less than 10 million barrels a day, which is more than required, while Kuwait has also gone further than it had pledged.

Despite this promising start to the agreement, the price upturn has come to a standstill. Last month, prices were relatively stable at around USD 55 per barrel. However, we believe this is not because countries have cheated on their quotas, which was previously a problem. In our view, the main reason that the price upturn is being held back is that US shale oil producers are increasing their output. The number of active drilling rigs is up and productivity gains in shale extraction are continuing.

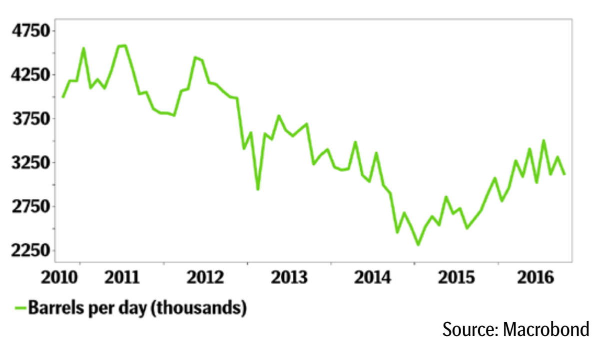
Since US shale oil producers are boosting production, it is difficult to foresee whether OPEC will be able to keep oil prices up. One hypothesis that has begun to circulate in the market is that OPEC has set a floor on crude oil prices of USD 50 per barrel, whereas US shale oil producers have capped the price on the upside at USD 60 per barrel. OPEC's official objective in cutting production is probably not primarily to push prices up but rather to quickly drain oil stockpiles, which are impeding the cartel's efforts to achieve balance between supply and demand. The supply cuts by OPEC and other oil-producing countries have just begun, and it will take a little while before they have an effect. For the first quarter of 2017, we have an average forecast of USD 55 per barrel and expect the highest prices of the year, an average of around USD 57.50 per barrel, to be reached during the second quarter before they revert towards USD 52.50 dollar per barrel at the end of the year. The partial recovery in prices from earlier lows has reduced the pressure on many oil-producing countries' public finances.

Gold – Safe haven in a politically uncertain world

Gold prices fell sharply after Trump's election victory, but they rose again in January (in seasonal terms, January and February are strong months for gold prices). Gold prices will go up to the extent questions are raised about whether Trump's policies will benefit the dollar or not. The market will correct for over-optimism about Trump's policies; after all, the US Senate must pass legislation before tax cuts and infrastructure investments can become a reality. Gold is good insurance against the political uncertainty now found in both the US and Europe.

In 2017, continued strong Asian demand and rising inflation trends will provide support for gold. The biggest threat should be that inflation is just a temporary effect of rising commodity prices and that we will once again see falling inflation later in the year. Nor should investors forget that gold is a volatile commodity.

THE US IS IMPORTING LESS OPEC OIL



The decline in US oil imports from OPEC during 2010-2015 was due to a sharp increase in US oil production. After that, US oil imports from OPEC rose as shale oil production became unprofitable and many companies went bankrupt. However, US oil imports from OPEC have again started to fall and should continue to fall since domestic production is once more on the rise and productivity is increasing rapidly.

RISING GOLD PRICES ON A FALLING DOLLAR

Investors have long used gold as a safe haven in times of turmoil. Because of the question marks generated by President Trump and his administration, together with political uncertainty in Europe, the Brexit process and elections in many key countries, we forecast rising gold prices.

Currencies

Cyclical currencies enjoy a tailwind

We believe the global economy will grow faster than over the past five years. This upswing should benefit commodity and emerging market currencies, which are traditionally sensitive to economic growth. Despite major political risks in both Europe and the US, financial markets should be able to handle these risks provided there is strong economic growth. Barring new surprises, the theme for participants in the foreign exchange (FX) market is the search for interest rate and yield spreads by buying currencies from countries with high interest rates and selling currencies from countries with low ones (the so-called carry trade). Countries that are experiencing rapid growth and offer attractive interest rates and bond yields will see capital inflows and a strong currency.

- EUR – Have we overestimated the political risks?
- USD – Have we underestimated the political risks?
- JPY – The yen is expected to remain weak.
- GBP – Uncertainty about the Brexit process should lead to further pound depreciation.
- CHF – Capital inflows will force the Swiss National Bank to cautiously allow the franc to strengthen.
- SEK – The Riksbank's key interest rate hike late this year will strengthen the krona.
- NOK – Isn't everyone just a little over-optimistic?

It may seem as if Brexit, Donald Trump and the potentially disastrous European elections to be held in 2017 should lead to more FX market uncertainty. However, so far financial market players seem to be taking these developments calmly. One strong contributing factor is that the global economy is expected to grow faster than a few years ago.

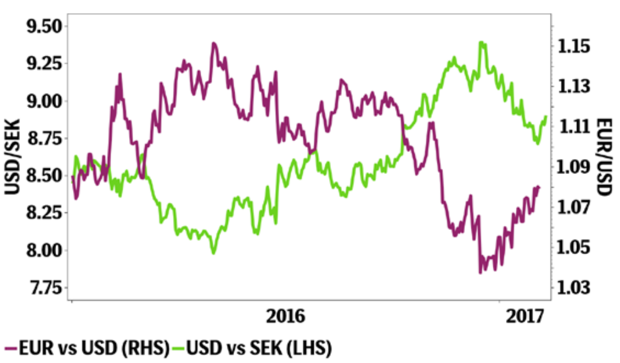
Cyclical/growth-sensitive currencies are strengthening at the expense of funding currencies such as the EUR, GBP and JPY, whose countries have low interest rates and accommodative central banks. As for the euro, many people (including us) may have overestimated the political risks. For instance, Marine Le Pen will need three times as many votes as in previous elections to win the Elysée Palace; that is not so likely to happen. But given how Donald Trump has begun his term in the White House, there are also political risks on the other side of the Atlantic, and we believe that the dollar will weaken in the short term. Market players have large dollar holdings and are counting on strong economic growth and expansionary fiscal policy. However, the most important argument for this strong belief in the dollar is the gap that still prevails between US and European monetary policy and resource utilisation – it is reasonable to believe that the Fed will continue its rate hikes while the ECB buys government securities. During the year as a whole, this will contribute to a lower EUR exchange rate against the USD.

China's official currency, the yuan (CNY), is also losing ground. The strong dollar trend has supported a capital outflow from China of nearly USD 2.5 trillion, but so far the country has the muscle needed to soften the depreciation in its currency. Since we believe the dollar will not rise especially much, the decline in the yuan will be relatively small; the CNY will lose about 5 per cent against the Swedish krona towards the end of the year.

EUR – Politics is taking a place on stage

Due to the spread of populism in the past year, with important elections to be held in several euro zone countries (the Netherlands, France and Germany as well as a potential snap election in Italy), the market is cautious about the euro. The European Central Bank (ECB) will also continue to pursue its highly expansionary monetary policy over the next 12 months. The FX market has discounted this and is avoiding exposure to the EUR. We believe the EUR/USD exchange rate will strengthen towards 1.10 during the first quarter (profit taking on the dollar) but that this appreciation will be short-term. The euro is not undervalued, the current account surplus is not enough to provide support, and the euro will remain a funding currency as the ECB continues to buy securities.

DOLLAR IN WEAKER PHASE – WILL REBOUND THIS SPRING



Source: Macrobond

USD appreciation came to a halt early in 2017 and we believe that profit-taking may boost the EUR/USD exchange rate to 1.10 before it starts declining again. The USD's rise against the SEK has also ended; we believe that the USD/SEK rate is already past its peak.

USD – Continued appreciation likely

The market has unilaterally focused on continued USD appreciation. There are also a number of reasons to believe the dollar will remain strong for a while: 1) economic growth is sufficiently robust, 2) fiscal policy will be more expansionary, 3) the labour market is strengthening even more, with wages and salaries rising and 4) the US Federal Reserve (Fed) will raise its key interest rate while other major economies – Germany, the United Kingdom, Japan and France – will keep theirs unchanged. According to our model, the USD is overvalued and the market has almost record-sized dollar holdings. Due to the Trump administration's aggressive confrontation tactics, a political risk premium is also priced into the USD. The USD has already reached highs against the Swedish krona, and we expect the USD/SEK pair to trade around 8.50-8.70 in the months ahead.

GBP – Low expectations after Brexit vote

Given the UK's government budget and current account deficits as well as the very uncertain Brexit process the country must navigate over the next two years, expectations about the pound are at a record low. It makes sense that the market is avoiding the pound, since economic growth looks set to decelerate in 2017. The pound has fallen nearly 15 per cent in trade-weighted terms since the Brexit referendum in June last year. However, it is too soon to buy the currency based on the argument that its valuation is cheap. Our forecast is that the GBP/SEK exchange rate will head towards a low 10 over the next 12 months.

JPY – Continued weakening expected

In 2016, the Japanese yen first surged before falling almost equally far. We believe that today's USD/JPY exchange rate of around 110-115 is reasonable. With future central bank actions anticipated and interest rates rising elsewhere in the world – and the Bank of Japan meanwhile expanding its balance sheet and enforcing a cap on 10-year bond yields – it is difficult to expect a stronger JPY. Due to the cyclical recovery, with continued moderate risk appetite and an FX market dominated by the carry trade, the JPY is being used as a funding currency and will weaken further.

CHF – Cautious strengthening due to inflows

Continued large capital inflows and rising FX reserves have forced the Swiss National Bank to gradually lower its EUR/CHF target from 1.08 to 1.07 and now 1.06. Meanwhile, it is clear that the country can deal with a "strong" CHF. In our view, the Swiss franc is only marginally overvalued. Inflation is positive again and the current account surplus is still close to 10 per cent of GDP. Given the risk of political turbulence in Europe and the ECB's continued monetary stimulus, we foresee a further strengthening of the franc, with the EUR/CHF rate sliding below 1.05. The Swedish krona should strengthen marginally against the CHF during the first half of 2017 but will continue towards a CHF/SEK rate of 8.50.

SEK – Stronger krona after Riksbank rate hike

The stronger krona trend was bolstered when the Riksbank's Executive Board split in December over continued rate cuts and bond purchases for 2017. Inflation has also been close to the bank's 2 per cent target. Our forecast is that the krona will continue to appreciate at a moderate pace this spring, since the trade-weighted krona (KIX) is already some 3 per cent stronger than the Riksbank's forecast. It is reasonable to believe that the Riksbank will remind the market about its potential to intervene if the krona keeps strengthening too much. However, Swedish economic growth is still very strong, and we expect the bank to deliver a rate hike late in the year, which will help bring the EUR/SEK rate below 9.00.

NOK – Stronger due to krone purchases

With oil prices stable at around USD 50-60/barrel and Norges Bank keeping its key interest rate unchanged at 0.50 per cent through 2019, expectations about the Norwegian krone should perhaps be lower than today's positive consensus outlook. But the central bank will continue to sell foreign currencies and buy the NOK on behalf of the country's sovereign wealth fund. Together with an attractive valuation, this should gradually strengthen the krone. During 2017, the EUR/NOK exchange rate will slowly fall towards 8.50-8.70; Norges Bank will not allow too rapid an appreciation. The NOK/SEK pair should continue to trend flat around what is also a long-term equilibrium rate (1.07).

CURRENCY PAIR	EXCHANGE RATE				CHANGE IN EXCHANGE RATE, %	
	Now*	Q1 2017	Q2 2017	Q3 2017	Q1 2017	Q2 2017
EUR/USD	1.08	1.10	1.06	1.05	*2.0*	*-1.8*
EUR/SEK	9.42	9.40	9.30	9.15	*-0.3*	*-1.3*
EUR/NOK	8.89	8.85	8.75	8.65	*-0.4*	*-1.5*
USD/SEK	8.73	8.55	8.77	8.71	*-2.2*	*0.4*
USD/NOK	8.24	8.05	8.25	8.24	*-2.3*	*0.2*
EUR/CHF	1.07	1.06	1.04	1.04	*-0.8*	*-2.7*
CHF/SEK	8.82	8.87	8.94	8.84	*0.5*	*1.4*
EUR/JPY	122	126.5	124	124	*3.4*	*1.4*
GBP/USD	1.26	1.24	1.20	1.20	*-2.1*	*-4.6*
GBP/SEK	11.03	10.56	10.57	10.46	*-4.2*	*-4.1*

**Currency forecasts were made by SEB Research & Strategy as of February 1, 2017. Please ask for a copy of our latest forecasts.*

Theme – Sustainability

An important trend is gaining strength

In today's society, most institutions, companies and individuals want to work and live in a way that shows concern for how they affect the world around them, which is usually referred to as their "impact". This also includes showing concern for how their money is invested and earns a return, as well as how it affects society and the environment.

Sustainability factors are increasingly being taken into account when regulations and laws are being drafted, and also when companies develop their business models. This means that the general level of sustainability in society has been rising. In recent years, explicit sustainability concepts have also been developed in the asset management industry, and sustainably managed assets have grown significantly in both Europe and the United States. New sustainable share indices and index funds are continuously being produced. Over 1,400 asset managers, who are responsible for investments of more than USD 59 trillion, have signed the UN Principles for Responsible Investment (UNPRI).

The trend towards sustainability is growing ever stronger. Starting in 2018, a new Swedish law will make it mandatory for major listed companies to publish sustainability reports. Several large pension funds, for example, Sweden's AP Funds and the Government Pension Fund of Norway, have begun divesting their investments in coal companies. One of the world's largest insurance companies, AXA, is divesting its tobacco company holdings. Factoring sustainability into investment decisions will soon be a legal requirement for all European Union pension funds under a new EU directive which was passed in November 2016.

Companies' incentives to become more sustainable are not only being driven by new regulations. The sustainability agenda often coincides with lower costs – by lowering emissions, companies can reduce the costs of raw materials and/or waste management. In a world with an increasing media focus, a good sustainability agenda also creates a stronger brand, which is important today when most of a company's value consists of intangible assets of which one vital element is goodwill. Prices of sustainable products are generally higher than for non-sustainable ones, in many cases enabling companies to increase their margins.

In response to growing demand from private individuals, the investment fund industry has also embraced the sustainability trend. Fund management companies usually take into account the sustainability of most of their products and are launching more and more funds with the word "Sustainability" in their names. Anyone who wants to invest and have a positive impact today has a broader palette of funds to choose from, compared to just a few years ago. Nowadays private individuals have a greater opportunity to choose the degree of sustainability and impact they want in their investments through ethical as well as sustainable funds.

Sustainability levels

Minimum integrity
Companies that manufacture weapons of mass destruction such as cluster bombs and land mines are excluded. Most actively managed funds in the Nordic countries already take this into account.

Exclusionary
This is the traditional way to invest on the basis of personal values. It excludes companies involved with tobacco, alcoholic beverages, weapons, gaming, etc. Funds most often use a ceiling of 5 per cent of total income from these activities.

Sustainable/ Environmental, social and governance (ESG)
This is a more modern approach to sustainable investing. Aside from a company's financials, investment decisions are also guided by various sustainability factors. Their fundamental purpose is to identify companies that have a positive impact because of the way they do business or procure raw materials. The fund industry is increasingly transitioning to this method.

Different approaches to ESG

ESG-conscious: Asset managers take sustainability issues into account in their decisions.

Best-in-class: First, managers perform an ESG rating. Then they rank the companies in each sector. They may then only buy shares of companies in the top half of the list, thereby avoiding the worst companies in each sector.

ESG momentum: Asset managers focus on companies not yet in the top half of the ESG list but that are actively working to improve in key ESG areas.

Fundamental ESG integration: A premium or discount is applied to a company's cost of capital, depending on how good or bad the company is from an ESG standpoint.

Thematic: Asset managers make investments exposed to specific themes – such as renewable energy, water, electric cars, etc.

Different levels of sustainability

A classic method among fund managers is to exclude companies involved with tobacco products and weapons (in many cases also with gaming and pornography). More and more people are now also choosing to remove coal and oil. This type of asset management has long existed in the form of ethical funds or share indices (e.g. FTSE4Good).

Over the past decade, funds with names including the word "sustainable" have emerged, most often under the broader concept of "ESG investing". ESG stands for Environmental, Social, Governance, which is now virtually synonymous with sustainable investing. In practice this means that in their investment screening process, managers take these factors into account.

One example of how a sustainable investing screening might work: Asset managers 1) look at various data such as a company's carbon or water footprint (environment), the number of women on the board, or the number of union employees (social responsibility) and the number of independent board members or damages paid (governance), 2) balance these parameters in various ways, usually depending on what is most important in that particular industry and 3) factor all this into their investment decisions in order to reduce the risk of adverse events such as corruption, scandals or production stoppages due to disgruntled employees.

However, the sustainability concept is fairly broad and means different things to different people. Most private individuals think mainly of the climate change issue and relate to renewable energy or companies that actively reduce their emissions (the "E" in ESG). Others think about companies that benefit society, for example through education and health care (the '"S" in ESG). At the same time, the job of asset managers is to generate returns, and they focus on factors that generate shareholder value, usually the "G" in ESG, for example, companies with good corporate governance. This means that the expectations of private individuals and the strategies of sustainable funds may differ.

Each fund manager has his or her own way of working with sustainability. Some sustainable funds have chosen to focus on companies that best live up to their criteria in each sector – which means that they may invest in oil and alcoholic beverage producers – while others completely exclude problematic companies and sectors such as fossil fuels. Sustainable funds may also invest in soft drink manufacturers such as Coca Cola or Pepsi because they have good business practices and great community involvement, even though research shows links between sugar consumption and increased health risks.

Various organisations try to help investors navigate through the sustainability jungle by labelling funds. On the European Continent these include Novethic, FNG and Luxflag. In Sweden a project is under way to apply the well-known Swan eco-labelling system to funds. Even the French government has joined the fund certification business. However, these certifications do not necessarily make the choice of funds easier for investors, since each label gives fund managers great flexibility in their sustainability approach.

In 2015, the United Nations agreed on 17 sustainable development goals, and sustainable fund managers are now trying to identify investments that are consistent with these goals. It is possible to achieve exposure to areas such as clean water, renewable energy, sustainable cities, innovation and infrastructure by purchasing the shares of companies that are active in these fields. This sector is usually referred to as "clean tech" or "environmental engineering", and interest in such investments is growing rapidly. Other areas such as education, poverty and hunger can be better supported by investing in the microfinance field.

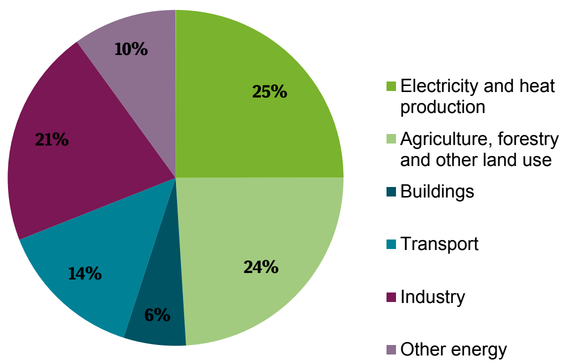
Environmental engineering for a sustainable society

The most obvious investment opportunity in environmental engineering is renewable energy, which we wrote about in the theme article "Wind power – a clean, economical energy source" (*Investment Outlook*, June 2016), since the energy sector accounts for 25 per cent of global green-

The UN's 17 sustainable development goals

- No Poverty
- Zero Hunger
- Good Health and Well-being
- Quality Education
- Gender Equality
- Clean Water and Sanitation
- Affordable and Clean Energy
- Decent Work and Economic Growth
- Industry, Innovation and Infrastructure
- Reduced Inequalities
- Sustainable Cities and Communities
- Responsible Consumption and Production
- Climate Action
- Life Below Water
- Life on Land
- Peace, Justice and Strong Institutions
- Partnerships for the Goals

THE TASK OF REDUCING GREENHOUSE GAS EMISSIONS CONTINUES



Source: EPA/IPCC 2014

To achieve their 2 degree Celsius climate target, the world's governments and enterprises are working to reduce greenhouse gas emissions. Energy production and industry account for a large proportion of such emissions, but agriculture and transport are other important areas to address since they account for 24 and 14 per cent of global greenhouse emissions, respectively.

house gas emissions. But renewable energy sources tend to have fluctuating production levels, which also creates a need for storage systems such as batteries. There is also a need to construct transmission lines from renewable power sources and to build up smart grids, which means that sub-contractors of energy producers may also be attractive investments.

The transport sector, which accounts for 14 per cent of greenhouse gas emissions, is also included in the environmental engineering category. It offers investment opportunities among car makers – a topic we touched on in our theme article "The car industry – a bright spot in Europe" (*Investment Outlook,* June 2016). Companies like Tesla are frequently mentioned when the topic of electric cars comes up, but most major car makers such as Nissan, Renault, Ford, BWM and Volkswagen also offer electric cars in the market. It is worth noting that in China, more than 10 car manufacturers produce electric vehicles and sales figures for "plug-in" vehicles exceed those of the US and Europe. As the market share of electric cars climbs and the number of self-driving cars increases, so does demand for semiconductors (see "Semiconductors – the backbone of digitisation", *Investment Outlook*, December 2016).

Companies that help reduce resource and energy consumption in society are also an important part of the sustainability equation. One example is the Norwegian company Tomra, which supplies recycling machines for aluminium cans. These machines help reduce energy consumption, since a can made of recycled aluminium requires 95 per cent less energy than an aluminium can made from bauxite. Another example is British-based Kingspan, which manufactures high-quality insulating materials used in climate-smart buildings. Sweden's Electrolux and Netherlands-based G-Star are trying to help clean up the oceans by manufacturing vacuum cleaners and clothing, respectively from recycled sea plastics.

Not only equity investments

Of course, sustainable investments not only consist of equities, but also include attractive opportunities among fixed income and alternative investments. Green bonds, sustainable bond funds and microfinance funds are examples of areas with a sustainability perspective. In general, however, the fixed income market is less transparent, making the supply of this type of investment more limited. Alternative investments are a broad category, and although there is a sustainability trend here too, just as in the fixed income segment the supply is smaller than in the equity segment.

How does a sustainability approach affect returns?

Depending on the sustainability level and approach, returns are affected differently. Several studies show that the classical ethical exclusion approach has no significant impact on returns. As for the more modern sustainable investing approach, studies show that it actually has a positive impact on share prices (although some recent studies indicate that sustainability is already factored into current share prices). In emerging markets, a sustainability approach seems even more profitable – but there is a shortage of fund managers who dare to follow such an approach in these markets.

Does it actually make a difference?

There is a general debate about whether you can really make a difference by choosing which companies to buy or sell, since shares simply change hands. Hardliners believe that you can only make a difference in society by deliberately supplying fresh capital to projects with returns below market levels – otherwise the investment would have been made anyway and you would not have made a difference. According to this line of reasoning, you can only have a positive impact by means of initial public offerings (IPOs), private equity or green bond issues.

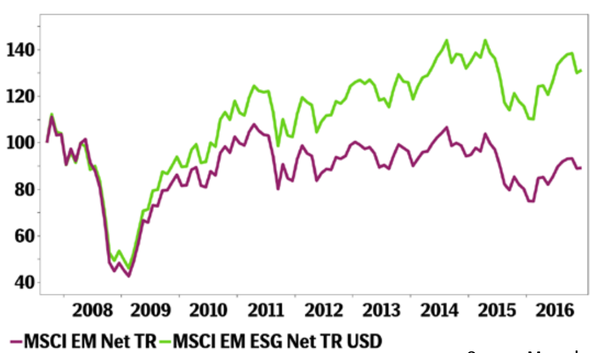
When we invest in a sustainable company we are supporting its share price, which indirectly leads to stability and enables the company to attract and retain talent – and possibly gain access to cheaper financing in the future through a higher credit rating. Studies show that companies with a strong focus on responsible business practices have low capital costs. It also provides a signal to small unlisted companies that there is a market for listed sustainable companies, which in many cases is essential to private equity firms that invest in and support small companies in the start-up phase.

Perhaps most importantly, sustainable fund managers engage actively in shareholder issues. We are seeing more and more of this as fund management companies join forces through various shareholder advisory organisations like UNPRI or Hermes EOS and establish a sustainability agenda together with company managements and boards.

Adapt your investments to your values

For private investors, it is ultimately a matter of adapting their investments to their values. The traditional approach has been to pair return targets and risk tolerance with different equities and bonds in order to find the right profile. Sustainability adds a third dimension – values – which differs from person to person. This development is moving ahead rapidly, and the goal is that individuals should be able to adjust these three different dimensions according to their own preferences. Some regard investments as a good and important tool for exerting influence, while others prefer to exert their influence by consuming in a more sustainable way or by voting for political parties with good sustainability policies. All of these areas are evolving continuously.

SUSTAINABILITY HAS BEEN POSITIVE FOR EM RETURNS



Source: Macrobond

In emerging markets, a sustainable approach has paid off, but the proportion of fund managers who dare to follow such an approach is small and investment opportunities are somewhat limited so far. The chart shows the performance of a broad emerging market index and an ESG index covering the same regions.

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