Investment Outlook

September 2017

SEB

In this issue:

This report was published on September 12, 2017. Its contents are based on information and analysis available before September 6, 2017.

Strong economy and central banks in the spotlight again

AS THE SWEDISH YEARLY dividend period ended late last spring, we chose to adjust the risk in our portfolios downward to a neutral position. The background to this decision was that in our assessment, investors were discounting rather too positive signals, and we felt that the potential for continued strong stock and credit markets was diminishing. In hindsight this was a suitable decision, since the Swedish stock market fell during the summer and foreign equity portfolios were hurt by a negative currency effect due to a weak American dollar.

In August we again adjusted our risk upward to overweight in equities and corporate bonds, driven by broad and stable economic performance and a quarterly report season that showed strength, even though not all companies lived up to high expectations. These expectations have changed somewhat during the summer, and more volatile markets indicate that the average investor has become somewhat less aggressive. Offsetting these positive driving forces, valuations remain high and risks include the fact that economic expansion has already lasted a long time and that central banks would like to slowly but surely raise their key interest rates and reduce their record-sized balance sheets. The actions of central banks are likely to be cautious, yet they are an important parameter since they have had a supportive function for both economic growth and the capital market. Since the 2008 financial crisis, central banks have bought huge quantities of bonds. We are now probably entering a new phase with somewhat higher growth and inflation and therefore less need for stimulus measures by central banks.

We may also be leaving the period of extremely low volatility behind us, but it is important to remember that volatility is choppiness, not an upward or downward trend – for example in the stock market. Long-term market trends are determined by economic and earnings cycles, valuations and any crises of major economic importance. This issue of *Investment Outlook* presents further details on these driving forces, their impact on each asset class and our view of risk exposure. The issue also includes two in-depth theme articles. The first one focuses on efforts to achieve greater energy efficiency, which are essential if we are to meet existing environmental targets. The second theme article examines the private direct loan market, which offers attractive investment alternatives in the prevailing low interest rate environment.

Wishing you enjoyable reading.

FREDRIK ÖBERG
Chief Investment Officer, Investment Strategy

Risk exposure and allocation

Summary

WE HAVE RAISED THE RISK LEVEL IN our portfolios to an overweighting of both equities and corporate credits. Weak market performance during the summer has improved valuation parameters somewhat, at the same time as we have seen further signs that the economy is gaining strength. This should result in a good environment for the corporate sector and company earnings-generating capacity. The clear appreciation of the Swedish krona was one reason why we chose an upward adjustment in our proportion of foreign equities, instead of Swedish ones.

Although the economic expansion has been under way for a long time, we believe that the risk of recession is low. What limits our risk appetite is that valuations are still on the high side and that the investor community has concentrated its portfolios on equities and corporate bonds. We must also count on gradually decreasing central bank stimulus and higher key interest rates.

RISK EXPOSURE	
SECOND QUARTER 2017	THIRD QUARTER 2017
NEUTRAL	OVERWEIGHT

Our risk exposure is based on the proportion of equities in a diversified portfolio. The weight of equities is described as underweight, neutral or overweight. What a neutral weight is will depend on what risk profile the individual portfolio has.

The following is a review of a number of important factors behind our market view and how they may influence future developments.

Growth and earnings: The expansion is broadening and is showing strength in all segments of the economy in all regions. This points to stability even though the economic upturn has lasted for a long time. Global inflation is around 2 per cent and is expected to remain at this level. This provides good opportunities for the corporate sector to deliver rising profits, but we have a healthy scepticism towards excessively high forecasts.

Central banks: The US Federal Reserve is continuing to hike its key interest rate and also intends to shrink its balance sheet (decrease the volume of fixed income investments it owns), which will reduce liquidity in the market. Other central banks are lagging behind, and the net effect of their actions on liquidity is expected to remain positive, but clearly less positive than before. Interest rates and yields should gradually rise. This will occur in an economic system with a high volume of debt, which will increase risks.

Valuations: This summer's earnings increase combined with a slight stock market downturn in Sweden has softened valuations a bit, but levels remain high in historical terms. In relation to valuations of government bonds or risk-free interest rates, valuations of equities and corporate credits are more normal, provided that economic growth lasts.

Risk appetite and positioning: This summer's stock market performance has represented a certain correction compared to less risky asset classes, but investors still have a large proportion of risk assets in their portfolios. Because of this, we are holding back our risk exposure, even though risk appetite is not yet at historical peaks.

Expected returns: Outcomes will be highly dependent on a correct growth forecast. We expect positive returns from most asset classes over the next 12 months. These expected returns are lower than historical averages, while risk is intact.

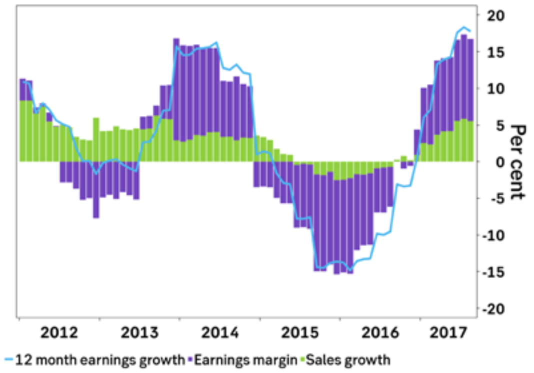
Examples of risks: Valuation levels and positioning by market players, high global debt, the potential negative effects of rising inflation, interest rates and bond yields, as well as central banks that gradually normalise their key interest rates and balance sheets. If the economic cycle should turn downward this would have a major impact, but we believe that the probability of this is low, even though the economic recovery and stock market upturn have been under way since 2009.

OUR PORTFOLIO MANAGEMENT

ASSET ALLOCATION

- In August we reverted to overweighting equities at the expense of fixed income investments. The overweight in equities is now in global stock markets. Last spring we overweighted both Swedish and global equities.
- In global equities we have continued to slightly underweight the US while overweighting other regions.
- Corporate credits with short maturities dominate our fixed income portfolios, while our alternative investments are characterised by a defensive hedge fund portfolio.
- Positive forces: The global growth rate and earnings generation, extremely low interest rates, relative valuations, expected 12-month returns.
- Negative forces: Global debt, absolute valuations, central banks in the medium term and US Federal Reserve (Fed) rate hikes in the near term.

EARNINGS GROWTH COMPONENTS, US COMPANIES



Source: Macrobond

The above chart shows moving 12-month earnings growth in the US (S&P500) divided into earnings margin and sales growth components. The later period in the chart shows earnings again being helped by higher sales, due to volume or prices or both. The same is true of other regions.

EQUITIES

- Because of strong macroeconomic data and a favourable report season, we are positive towards equities.
- Low interest rates and yields, plus a good liquidity supply, will continue to help sustain stock markets.
- Relatively high valuations will reduce upside potential.
- Exchange rate movements will create uncertainty about earnings.
- Healthy growth and relatively low valuations will benefit emerging market (EM) equities.
- A strong Swedish krona will hurt the export-heavy Stockholm stock exchange, which will nevertheless benefit from the growth situation.
- Weak currencies in other countries will decrease SEK returns on international investments.

MARKET	TACTICAL EXPECTATION (12-MONTH FIGURES)	
	RETURN	RISK
Global equities	5.7%	11.7%
Emerging market equities	7.5%	13.3%
Swedish equities	8.7%	12.1%

Source: SEB

FIXED INCOME INVESTMENTS

- We expect a Riksbank key interest rate hike in April 2018.
- We believe the European Central Bank will announce this autumn that it will reduce bond purchases.
- The Federal Reserve will normalise policy both via its key rate and its balance sheet.
- Corporate credits have benefited from the market situation and monetary policy.
- A weak USD and stronger commodity prices will help sustain emerging markets.

MARKET	TACTICAL EXPECTATION (12-MONTH FIGURES)	
	RETURN	RISK
Government bonds	-1.6%	1.8%
Corporate bonds, IG*	-0.2%	3.2%
Corporate bonds, HY**	1.3%	5.9%
Emerging market debt	5.8%	11.8%

*Investment grade **High yield

Source: SEB

ALTERNATIVE INVESTMENTS

- A lack of volatility creates obstacles. Reactions to Q2 corporate reports are creating potential for equity long/short.
- The lack of clear trends is a headache for CTA hedge fund managers.
- The OPEC+ production cap agreement is crucial to continued stable oil prices.
- This summer's metal price upturns are explained by increased net demand in China and the falling USD.

MARKET	TACTICAL EXPECTATION (12-MONTH FIGURES)	
	RETURN	RISK
Hedge funds	3.5%	6.0%
Commodities	N/A	11.5%

Source: SEB

Tactical expected return is based on the SEB House View as of September 4, 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.

Market view – macro

Late-cycle growth increase

Now that growth is clearly accelerating and the economic cycle is maturing, there is also a transition in three economic phenomena. Soft macroeconomic data are being followed by hard data, weak demand is turning into resource shortages and the growth engine is shifting away from the United States. Overall, we are still optimistic about the prerequisites for growth as well as inflation during the next couple of years – a good background situation for risk assets.

In our last *Investment Outlook* (published in May 2017) we stated that growth indicators, which had been strong for some time, were about to be followed up by an actual growth increase, reflected in “hard data”. We also noted that there was a wide gap between strong indicators and then-sluggish growth. This is where the first transition is under way, and it is occurring in the “right” way – with a surge in economic growth. In recent years we have seen a tendency towards such upswings failing to materialise, with downward revisions in growth forecasts as a consequence. But these hopes had been connected to a single region or factor.

Broad-based growth

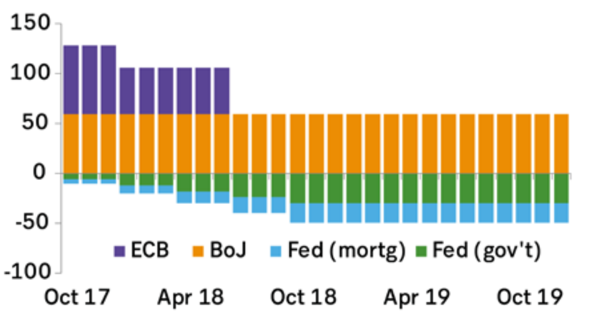
This time around, the growth increase is obviously broad-based in regional, national and sectoral terms, although US growth is not impressive. The parts of the economy that are most clearly showing strength are the labour markets in both the US and Europe, vigorous growth in China driven by a manufacturing upswing, an increase in capital spending due to rising capacity utilisation and a cyclical recovery in various emerging market countries. The overall outcome is a robust picture. We expect global growth of 3.8 per cent both this year and next, and one tenth of a point lower in 2019. This is both above average growth and above consensus.

As for the overall driving forces of the economy, they can be summarised as a transition from a long period of subdued demand to increasing resource shortages. Ever since the financial crisis and the deep recession of 2008-2009, the world economy has been struggling with a clear demand problem. Final demand in the form of private consumption and capital spending has been weak, driven by low general capacity utilisation – especially a weak labour market. Concurrently with this, demographic headwinds and weaker productivity growth have lowered potential growth.

The overall outcome was a long period of anaemic growth, sustained by aggressive monetary policies. Because of this sluggish performance, economists have spoken of “secular stagnation”: a long-term state of slow growth. But in recent years, growth – though anaemic – has led to a slow improvement in the outlook. Labour markets, especially in the US, have shown clear strength. Together with rising asset prices, this has boosted household optimism and to some extent the inclination to consume.

Meanwhile companies have gradually grown into their production resources. Overall, we now have a world economy in which various major regions are close to full capacity utilisation. These are classic signs of a

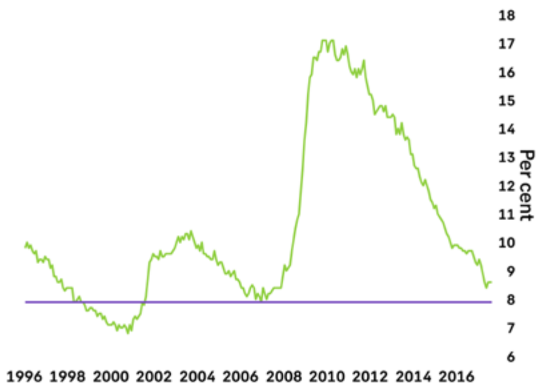
REDUCED BUT CONTINUING STIMULUS MEASURES



Source: ECB, BoJ, Fed, Macrobond

The US Federal Reserve (Fed) will probably begin the process of shrinking its bond portfolio during the fourth quarter of 2017. This may create market instability; liquidity supplied by central banks has helped sustain both economic growth and markets in the past 7-8 years. Other central banks, especially the Bank of Japan (BoJ) will nevertheless continue supplying liquidity. On a net basis, the market will be supplied with about USD 1 trillion more liquidity during 2018.

MOVING TOWARDS FULL EMPLOYMENT – AND INFLATION?



Source: US Bureau of Labor Statistics, Macrobond

Official US unemployment is now below NAIRU, the equilibrium level where pay increases traditionally start accelerating, which usually generates inflation. But this relationship seems to have weakened, and broad measures of employment indicate that there is still slack in the labour market.

maturing economic cycle, which generate expectations of rising inflation due to resource shortages. US wages and salaries are one example of inflation that "ought to" rise, especially now that unemployment has crept below its so-called equilibrium level. We are expecting somewhat larger pay increases ahead. Along with inflation close to the Fed's 2 per cent target, this will give the central bank ammunition for continued withdrawal of stimulus measures. It will do this by hiking its key interest rate and by initiating a reduction in its balance sheet. But it is important to note that this withdrawal is occurring from an extremely stimulative situation and that other central banks, especially the Bank of Japan, are continuing to stoke their economies with stimulus programmes. Overall expansionary monetary policies will help keep growth at healthy levels, but growth will decelerate marginally during 2019 as resource shortages make themselves felt.

The August issue of SEB's *Nordic Outlook* research report describes both this main scenario and its risks in greater detail. Rapidly rising inflation, policy errors by central banks or geopolitical unrest that escalates to the point of impacting world trade are factors that may threaten this bright picture, but at present we foresee no clear signs that these threats will materialise.

Better economic momentum in Europe

The third transition is perhaps not so prominent, but concerns a regional shift in growth. *Nordic Outlook* provides a thorough review of the situation in the various economies. By way of summary, we can state that many hopes were previously attached to a surge in the US economy. We foresee an acceleration there, but not at the level of earlier expectations. Fiscal stimulus measures look set to be disappointing, since the Trump administration is having difficulty pushing through various reforms. Meanwhile a relatively low household savings ratio is holding back consumption increases, but growth will benefit from capital spending and net exports thanks to the weaker US dollar. We expect growth of just above 2 per cent in the next couple of years, a bit above trend.

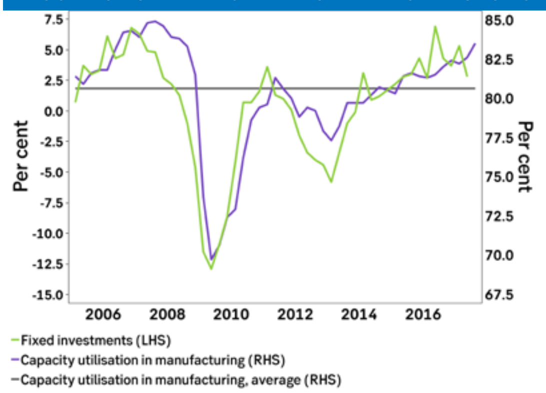
Unlike the US, Europe is providing upside surprises. The upturn is broad-based and is being driven both by job growth and improved household optimism, as well as by increasing capital spending and rising exports. Our growth forecast is just above 2 per cent here as well, both above consensus and the long-term growth trend. In politics, this year's focus on national elections will be replaced by efforts to create deeper euro zone collaboration. Meanwhile Brexit negotiations will continue, with a significant deceleration in the British economy as the clearest consequence.

Emerging markets are driving global growth

Emerging market (EM) economies are also contributing to the healthy growth picture. China's expansion has surprised on the upside, but the economy will soon decelerate as planned. India continues its strong growth. More commodity-dependent economies such as Russia and Brazil can expect a cyclical recovery, but hampered by structural problems. In the EM countries we analyse, we expect aggregate growth of around 5 per cent in the next couple of years.

The Swedish economy is also among the bright spots from a growth perspective. We foresee broad-based, above-trend expansion with housing investments as the strongest driving force, followed by exports. Consumption will increase more sedately, despite a strong labour market. We also see risks of overheating as both monetary and fiscal policy remain expansionary. In the other Nordic countries, too, we expect rising growth, mainly driven by cyclical recovery both at the international and national level.

ROOM FOR GREATER CAPITAL SPENDING IN EURO ZONE



Source: Eurostat, Macrobond

After a number of years of relatively low average capacity utilisation and thus low capital spending, we are now seeing a surge in investments due to resource shortages at companies. Meanwhile rising home prices and low interest rates are stimulating construction.

GDP – YEAR-ON-YEAR % CHANGE	2016	2017 (F)	2018 (F)	2019 (F)
United States	1.5	2.2	2.4	2.0
Japan	1.0	1.3	0.8	0.7
Germany	1.9	2.1	2.0	1.8
China	6.7	6.8	6.4	6.1
United Kingdom	1.8	1.5	1.0	1.2
Euro zone	1.8	2.1	2.2	2.0
Nordic countries	2.1	2.5	2.3	2.2
Sweden	3.2	3.2	2.8	2.4
Baltic countries	2.0	3.5	3.3	3.1
OECD	1.8	2.1	2.1	1.9
Emerging markets	4.3	4.9	5.0	5.0
The world (PPP)*	3.1	3.8	3.8	3.7

Source: SEB, OECD

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

Global equities
Growth increase helps sustain earnings

This past quarter was characterised by strong macroeconomic data and generally strong corporate reports internationally. As a negative counterweight, there was political turbulence in the US as well as geopolitical instability in Asia, courtesy of North Korea, and large exchange rate movements. During the quarter, the world equity index in local currencies climbed by several per cent, while returns were negative for Swedish investors due to the appreciation of the krona.

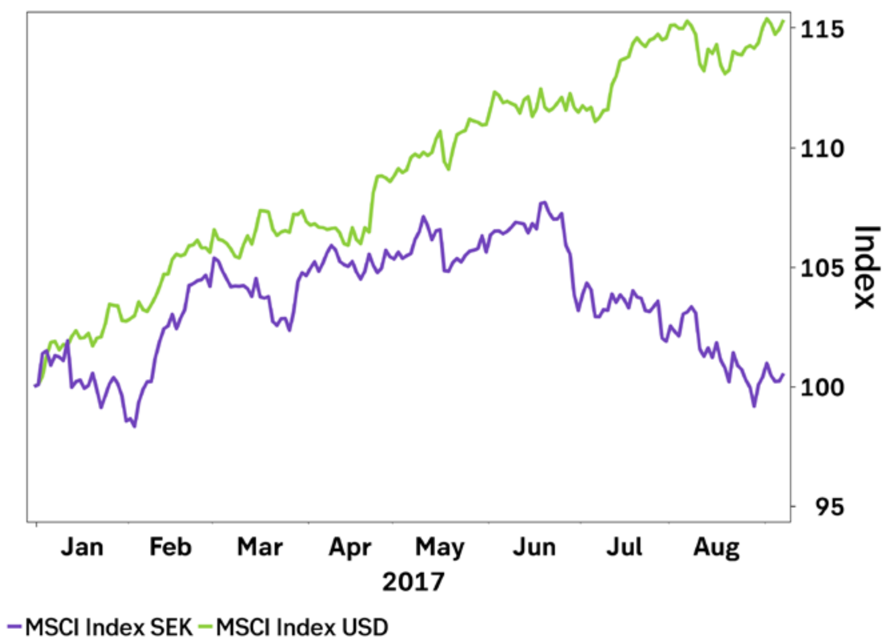
THE US DOLLAR'S SHARP DEPRECIATION against the Swedish krona and the euro has had an impact on the returns provided by a global equity exposure during 2017. The dollar weakened by 12 per cent against the krona and the euro by the end of August. Since US-based shares account for more than half of the MSCI world equity index, USD depreciation strongly affects the returns received in Swedish kronor, for example via a global fund. Measured in SEK, the world index climbed by only 0.5 per cent this year (until August 31). During the same period, the US stock market lost more than 3 per cent and European stock markets gained 5 per cent while emerging market (EM) equities performed best, gaining 12 per cent, calculated in SEK.

Measured in local currencies, however, the world index returned 11 per cent: Europe 5.5 per cent, the US 10 per cent and EM equities 23 per cent. The technology sector stands out, up 26 per cent in local currencies until August, which is far better than the second-ranking materials sector (+15 per cent). The oil and gas sector stands out as a big loser, having fallen by 10 per cent since the beginning of 2017; this is a reaction to the oil price decline as well as last year's strong performance.

Large exchange rate effects

This year Swedish investors have only received a return of 0.5 per cent on global equity exposure, while American investors have received 14 per cent. Foreign exchange (FX) exposure has thus been the most decisive performance factor. As a rule, equity funds have full FX exposure, so the outcome for Swedish investors has been meagre this year. However, exchange rate movements tend to even out over time. For example, the dollar has been at current levels no fewer than 10 times since 1984.

EXCHANGE RATE EFFECTS HIGHLY POSITIVE FOR DOLLAR-BASED INVESTORS



Source: Bloomberg

During 2017, a clear US dollar depreciation has benefited American investors in the world's stock markets, but for SEK-based investors the trend has not been equally cheerful. However, our assessment is that during the rest of the year the krona will weaken against the dollar and an exposure to global equities should thus pay off nicely.

Investors obtain good diversification in their portfolios by owning both Swedish and global equities. We have a positive view of equities and believe that the krona will weaken against the USD until the end of 2017, thereby enabling Swedes to achieve good returns via global equity exposure compared to current levels.

The second quarter 2017 report season showed a long-awaited breadth in earnings performance. Companies confirmed global economic growth via improved order bookings and sales. Although companies surpassed high expectations, the market's reception of the report period has been cool. This is partly explained by strong expectations, but also prevailing general concerns about the Trump administration, which weakened the dollar. In addition, the geopolitical situation around North Korea has worsened.

Tailwind in Europe

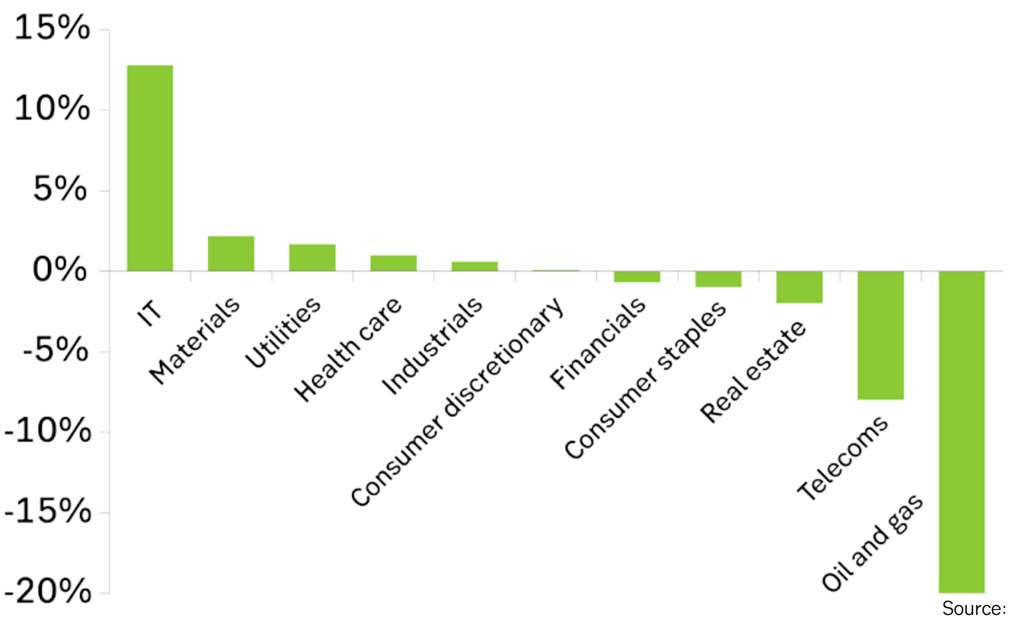
In Europe, earnings growth is finally gaining serious momentum. At the aggregate level, companies increased their sales by 7 per cent and earnings by 30 per cent compared to the second quarter of 2016. We are seeing the largest earnings improvements among oil and mining companies, due to price increases for the underlying commodities. Other cyclical sectors such as industrials, consumer discretionary goods and banking also show a high rate of improvement. Improvement figures have been high in Europe because the region is early in its cyclical recovery phase and comparative figures are therefore low.

The banking sector, previously weighed down by problems, is the single largest sector in Europe and an important lubricant for the economy, since a large proportion of corporate loans come from banks – unlike in the US, where companies mainly borrow via the capital market. Bank capitalisation is continuing to improve as credit quality improves and earnings rise. Parts of the European banking system are still struggling with a high proportion of bad loans and undercapitalisation, for example in Italy. The situation eased somewhat after the Italian government supplied funds to recapitalise Veneto Banca and Banco Popolare di Vicenza. However, the general perception of the European banking system is that risks have decreased significantly. This is apparent from the pricing of bank bonds and derivatives. Not even the write-down of Banco Popular's high-risk bonds in Spain to zero managed to shake this perception. When the European Central Bank (ECB) normalises its key interest rates, this will lift the profitability of the European banking sector. Our assessment is that this will begin to happen in the second half of 2018, after the first ECB deposit rate hike occurs.

Technology is driving US equities

In the US, second quarter reports provided positive surprises both in terms of earnings and sales. Earnings grew by 10 per cent and sales by 5 per cent, which are strong figures given that the US is in a late growth phase. Aside from oil companies, whose earnings climbed sharply, the stand-outs were technology companies – with sales growth of 10 per cent and earnings increases of 15 per cent at an aggregate

2017 MSCI WORLD INDEX PERFORMANCE, MEASURED IN SWEDISH KRONOR, BY SECTOR



Source: Bloomberg

The MSCI World Index is dominated by the information technology (IT) and banking sectors, which together make up about 36 per cent of the total. The technology sector accounts for nearly 18 per cent of the Index and was by far the biggest contributor to this year's positive performance. Without this sector, World Index performance would have been negative in SEK.

level. Such giants as Apple, Facebook, Microsoft and Alphabet (Google), the world's four biggest companies in terms of market capitalisation, belong to this fast-growing sector. Facebook is the fastest-growing of these four. Its shares have gained 100 per cent during the past two years, driven by impressive earnings performance. Facebook stood at USD 38 per share five years ago and was regarded as sharply overvalued at that time. Today a share costs USD 166 and is trading at a price/earnings (P/E) ratio of 29. This is not an entirely unreasonable valuation, given the company's expansion, and a reminder that consumer-oriented companies operating via the Internet can grow explosively. Market potential and expansion rate are important parameters when analysing this type of growth company in its early phase, while traditional valuation metrics are less effective in estimating their fair value.

Advances in China's information technology (IT) sector are also impressive. Tencent and Alibaba are now the biggest listed Chinese companies in terms of market capitalisation and are among the top ten such companies in the world. The two are expected to increase their sales by 50 per cent and their earnings by more than this between 2016 and 2017. Tencent's share price is up 70 per cent this year and Alibaba's 95 per cent. Behind their success is the rapidly increasing use of the Internet in China, mainly in such fields as "e-tailing", social media, mobile payments and online gaming. It naturally makes things easier for these Chinese companies that the operations of foreign competitors are essentially banned in China. The IT sector accounts for 27 per cent of a broad emerging market index, and the rise of China's IT giants has been instrumental in the positive trend for EM equities in a global perspective.

Valuations are still relatively high. The P/E ratio for the global stock market in 2017 is 16.7, but we do not expect any major near-term change. The big test for valuation levels will occur when key interest rates are normalised.

MARKET	P/E RATIO, 2017	RETURN ON EQUITY, %
Emerging markets	13.6	9.3
Japan	13.8	6.7
Europe	15.5	8.9
United States	18.9	16.2

Source: Bloomberg

The table shows valuation multiples based on regions. The US stock market has high valuations compared to earnings, but also shows significantly higher profitability than elsewhere.

Looking ahead at 2018, valuations look more attractive since overall earnings growth is expected to be about 10 per cent compared to 2017.

Positive outlook dominates

Because of strong macro data, coupled with a positive report season and our belief in a weakened krona until year-end, we are positive towards global equity exposure in the short to medium term. Global equity exposure also offers attractive risk-adjusted returns, since the Swedish krona tends to weaken during any crises. We remain positive towards EM equities, since their valuations should approach those of advanced economies. The dominant element of IT and bank shares in the EM sphere should also continue to perform better than other markets. We remain positive towards underlying performance in Europe and Japan, but due to the appreciation of the EUR and JPY against the US dollar, overall we believe that the American, European and Japanese stock markets will behave similarly for Swedish investors. Measured in local currencies, however, the European and Japanese stock markets should perform better than the American market.

Nordic equities
Currencies strike back

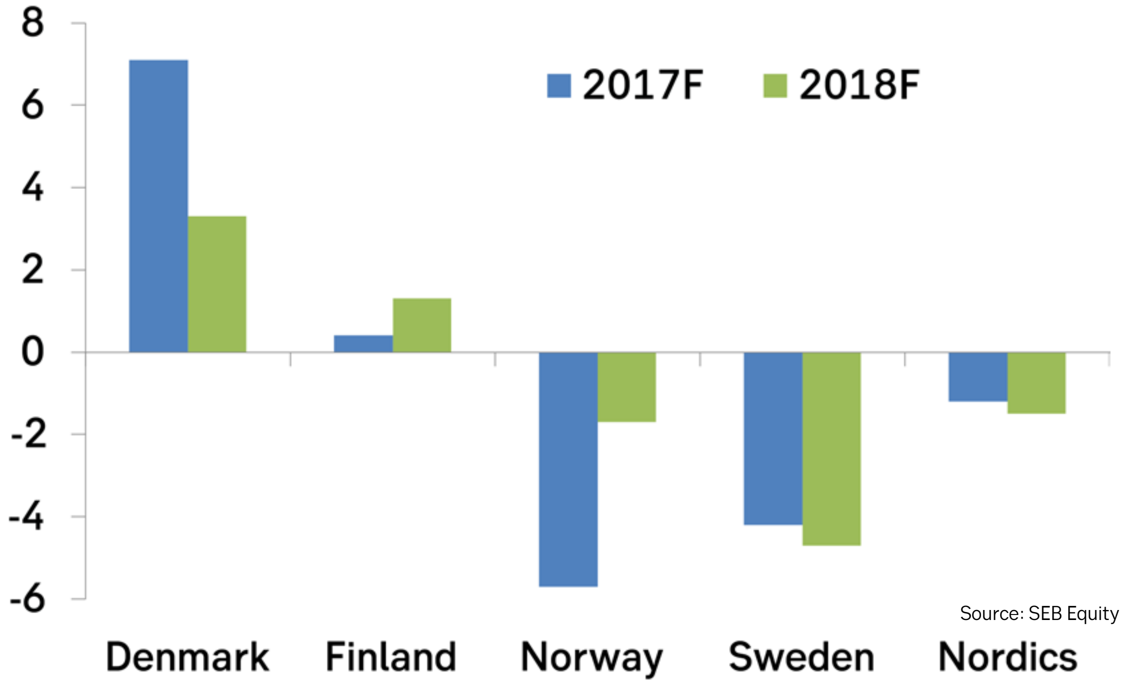
Following a robust start to the stock market year, the Swedish equity index slumped during the summer. This was due partly to a downward adjustment in previously excessive expectations of both corporate earnings growth and future US fiscal stimulus measures, but also to an unfavourable currency trend for industrial companies. The conflict with North Korea has made matters worse. High valuations had also made the market sensitive to any kind of setback. On the positive side, the global economic recovery appears to be sustained while interest rates and yields are at historical lows and investors still seem to have substantial liquidity. These last two factors provide good support and are among the reasons for our continued cautiously optimistic stock market view.

FIRST-QUARTER CORPORATE EARNINGS REPORTS were exceptionally rosy. This was the best earnings season relative to expectations in many years, not just in the Nordic countries but all of Europe. Unfortunately, it turned out to be "an unsustainably good level," as the Senior Vice President Controlling and Finance (CFO) of Sweden's biggest industrial company, Atlas Copco, recently noted at an investor seminar organised by SEB. After a period of earnings forecast stability at the start of the year, we have thus unfortunately been forced once again to revise our earnings forecasts significantly downward during the most recent three-month period. For companies listed on the Stockholm stock exchange, we have cut expected earnings growth by more than half since early June and now expect earnings growth in 2017 of about 4 per cent. Although we still have more positive 2018 and 2019 earnings growth forecasts for companies on the Stockholm stock exchange – 11 per cent and 9 per cent respectively – after the steady downward-revision trend of the past seven years, investors will probably have relatively limited optimism about next year and the year after if we do not see similar strength in the near future as well.

Companies with a proven ability to generate earnings growth, regardless of general economic and exchange rate trends, should therefore have good potential to gain popularity again with investors.

Looking at the other Nordics, the picture is not as gloomy. Although earnings growth forecasts for Nor-

LOWERED EARNINGS FORECASTS



Source: SEB Equity Research

The chart shows earnings forecast revisions in per cent during the past three months for companies listed on the Nordic stock exchanges, with a breakdown by country. There have been substantial downward revisions in Sweden and Norway, whereas forecasts have been revised upward in Denmark and Finland. Relative to the expected level of growth, the downward revisions for Swedish companies are by far the biggest.

wegian companies have also been revised downward substantially, but from significantly higher levels, we still expect an increase in adjusted net earnings of 35 per cent for this year and 26 per cent for next year in Norway. In Finland, forecasts have been revised upward marginally, while in Denmark there have been significant upward revisions – even excluding the capital gain from A.P. Möller-Maersk's sale of Maersk Oil, which paints a somewhat rosier 2017 forecast for companies there. For the Nordics as a whole, we still anticipate healthy earnings growth of 11 per cent this year, followed by 13 per cent in 2018 and 10 per cent in 2019. One key reason for the more positive trend in Denmark is that the Copenhagen stock exchange has quite a different composition from its Stockholm counterpart, with far larger elements of health care, chemical and environmental technology companies, whereas heavy industry is a far bigger component of the Swedish stock market. The high earnings growth expected in Norway is mainly a function of the strong earnings recovery expected in the oil sector following the crisis of last year.

Krona appreciation is pushing down earnings

One important explanation for the deterioration in earnings outlook can be found in the more unfavourable currency trend for Swedish industry. So far this year, the Swedish krona has strengthened by 13 per cent against the US dollar and 8 per cent against the Chinese yuan, which is partly pegged to the dollar. This has had a sharply negative effect on the earnings of industrial companies, mining and forest product companies as well as on the value of earnings generated by subsidiaries of Swedish listed companies in the US and China. Although there is also some positive effect from lower costs for retailers with large dollar- and yuan-denominated purchases from Asia, the net effect is still clearly negative for companies listed on the Stockholm stock exchange, especially when dynamic effects such as exchange rate-driven price adjustments are included.

White House circus reverses Trump effect

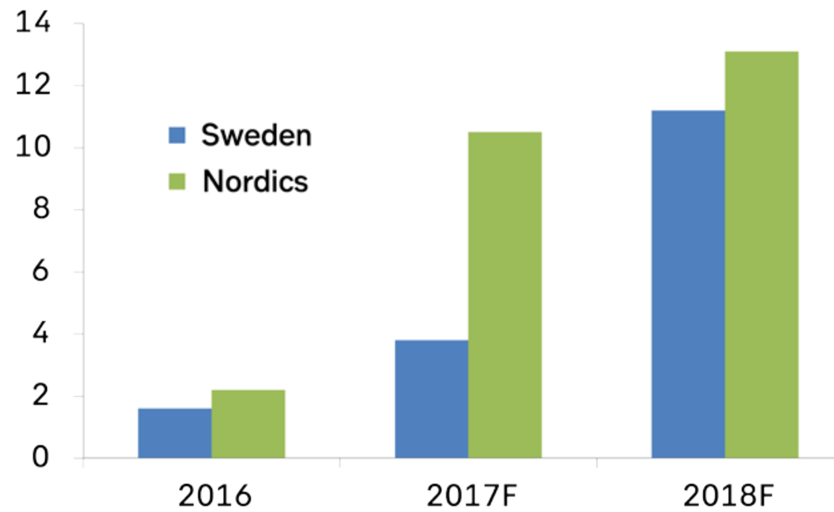
When it was clear that Donald Trump had won the presidential election, many people in Europe and Asia were surprised by the optimism that spread through the US stock market and around the world. But months have gone by, and paralysing divisions in the Republican Party seem to be preventing promised reforms, while the White House is characterised by a high employee turnover in key positions and bad relations with the outside world. Hopes of stimulus in the form of tax cuts, deregulation and infrastructure investments, which generated great investor enthusiasm in late 2016, have now faded considerably again. On the positive side, worries about such areas as environmental technology and health care – which investors feared earlier this year would be hit by reduced regulatory support and tougher price pressure, respectively – have eased, benefiting Nordic makers of wind turbines, biofuels and pharmaceuticals, for example.

It is also worth noting that the US economic recovery has already been under way for a relatively long time, with unemployment down to just above 4 per cent – its lowest level since 2001. From this standpoint, it is not necessarily detrimental to the stock market in a somewhat longer-term perspective if the fiscal stimulus measures discussed in the US fail to materialise.

Commodities confirm the strength of the economy

In the May issue of *Investment Outlook*, we highlighted the risks associated with the fall in commodity prices late in the spring and what the consequences would be if this continued. Our main scenario was always a quick recovery, but there was a clear risk that the situation could develop differently. The energy and metal sectors have been important drivers of economic fluctuations in recent years, including both the downturn in 2014-2015 and the recovery in 2016-2017. These sectors have had a substantial impact on the earnings of Nordic listed companies, both through direct effects on oil and

WE STILL EXPECT GOOD EARNINGS GROWTH IN THE NORDICS



Source: SEB Equity Research

The chart shows expected earnings growth for Swedish and Nordic listed companies, respectively, over the next couple of years. Continued substantial earnings growth is expected both this year and next in the Nordic countries, but forecasts for Sweden for 2017 were lowered significantly after second quarter reports.

commodity companies and their subcontractors and more indirect effects via the impact of the general economic trend on commodity-driven economies such as Brazil and Russia. Among Nordic companies with a large exposure to one or both of these countries are Electrolux, Volvo, Saab, Carlsberg and Nokian Tyres. However, during the summer we saw a strong recovery in metal prices generally, which among other things benefits the many large Nordic subcontractors to the mining industry. Oil prices have also stabilised at what is apparently an acceptable level for this industry. One earlier cause for concern can thus be considered eliminated; given commodity price increases this summer, it has even been transformed into a positive factor for the stock market. For example Sandvik, one of the world's leading suppliers of equipment to the mining industry, notes that the copper price trend should create potential for a broader recovery in mining industry investments. It is also natural to see the rally in metal prices as a sign of a positive trend in industrial activity.

Uplifting message at SEB's investor seminar

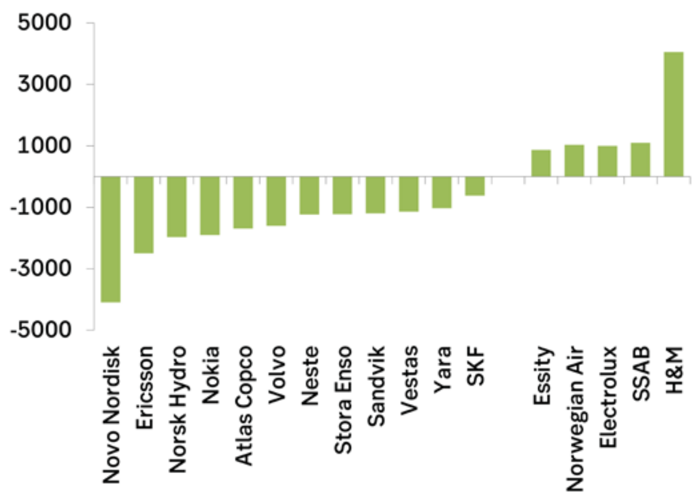
Nor is it only investments in commodity extraction that are on the rise. In late August, SEB held an investor seminar attended by the CEOs or CFOs of eight of the largest industrial companies on the Stockholm stock exchange. Without exception, their message was positive regarding the demand situation in essentially every geographic area and almost every customer segment (except the offshore-based oil and North American auto industries). Naturally, most participants meanwhile complained about the recent exchange rate trend, but the underlying market trend was described in nothing but positive terms. Although the atmosphere is far from euphoric, these corporate leaders apparently foresee a clear improvement in the demand situation compared to last year. The mood is more positive than at the same time last year and the year before. The pace of improvement has slowed somewhat compared to the first quarter of this year, but the trend is still in the right direction. Meanwhile, corporate leaders are confident about their own ability to generate productivity improvements and cost savings. Many seminar participants also noted how technological advances in society, especially digitisation, are driving both demand for their company's products and cost-saving opportunities. This message offers hope that current earnings forecasts are sustainable, provided that the exchange rate situation does not deteriorate further.

Conclusion: A favourable combination

A recently published survey of institutional investors indicates that a record-high proportion of them, almost half, think that equities are overvalued today. So one can scarcely ignore the fact that, even after the summer downturn, the Nordic stock market is highly valued from an historical perspective, with a price/earnings ratio of 16.5 based on our earnings forecast for the next twelve months: a premium of 11 per cent compared to the average for the past ten years.

However, we think that given the close to non-existent alternative returns in the fixed income market, valuations for equities that are higher than the historical average are well justified. We also see good potential for many companies to pay higher dividends going forward; there is a long list of overcapitalised major Nordic corporations. One alternative to paying more dividends is acquisitions, which also bodes well for a continued rapid pace of sectoral restructuring deals. Such corporate deals also tend to fuel the stock market, especially in the short term. The earnings trend still looks set to be positive for this year and next, although these figures have been revised downward recently. All in all, we continue to have a positive view about the performance of the Nordic stock markets in the coming year.

WINNERS AND LOSERS FROM A WEAKER DOLLAR



Source: SEB

The chart shows the static effect on pre-tax earnings in Swedish kronor for some of the Nordic large caps with the largest dollar exposure, in case of a 10 per cent US dollar depreciation against the financial reporting currency of each company. Industrials, telecoms and commodities dominate the list of losers, while consumer-oriented companies with dollar-denominated purchases may benefit.

Fixed income investments

Slow rise in long-term yields

Bolstered by strong macroeconomic data, central banks have shifted their focus from stimulus to tightening measures. We believe increasingly hawkish tones from central banks will lead to higher interest rates and yields, but this rise will be limited somewhat by weak inflation pressure.

Government bonds (excl emerging markets)

We are sticking to our forecast of an initial interest rate hike by Sweden's Riksbank in April 2018. The general economic trend is providing ever greater justification for a shift in the central bank's monetary policy. Apart from domestic economic strength, continued Fed rate hikes and the ECB's cautious policy shift suggest that the Riksbank will raise its key interest rate somewhat earlier than indicated in its current rate path, which signals an initial hike in the summer of 2018. The low interest rate environment around the world and inflation that is not quite picking up point to gradual, controlled rate hikes. The Riksbank wants to make sure there is a sustained increase in inflation, while countering krona appreciation. We expect two interest rate hikes per year of 0.25 per cent each, which would mean a repo rate of no more than 0.5 per cent at the end of 2019. Increased expectations of Swedish key interest rate hikes should in turn lead to a rise in Swedish long-term yields. In our view, 10-year Swedish government bond yields will rise to 0.85 per cent at the end of 2017 and will reach 1.50 per cent at the end of 2018.

Stronger economic growth combined with a bright outlook in Europe will pave the way for a new ECB decision soon to reduce its stimulative bond purchases. Meanwhile, the inflation outlook is still weak. However, we expect that this autumn the ECB will announce a reduction in monthly bond purchases from 60 to 40 billion euros starting in January 2018 while extending the programme by six months, before terminating its bond-buying in conjunction with its June 2018 meeting. We believe the ECB's deposit facility rate (paid to banks overnight) will be raised from -0.40 per cent to -0.25 per cent in June 2018, and in 2019 the ECB will move to raise its refi rate twice to 0.50 per cent.

The US Federal Reserve (Fed) will continue to normalise its monetary policy. Our main scenario is another hike in its key interest rate in December 2017. The Fed is also expected to start shrinking its balance sheet and, in our view, will begin unwinding its bond holdings starting in the fourth quarter this year. In 2018, three rate hikes are expected, and we believe that as economic growth slows in 2019, the Fed will be satisfied with a single rate hike. That will bring its key interest rate to 2.5 per cent at the end of 2019. The Fed's plans to start gradually shrinking its balance sheet during the autumn may lead to a rise in long-term government bond yields. However, we believe that this effect will be limited, since the Fed is probably aiming for a larger balance sheet overall than before the 2008 financial crisis and will take its time in order to limit the upturn in interest rates. Our forecast is that US 10-year Treasury yields will rise to 2.50 per cent at the end of 2017 and 2.80 per cent at the end of 2018.

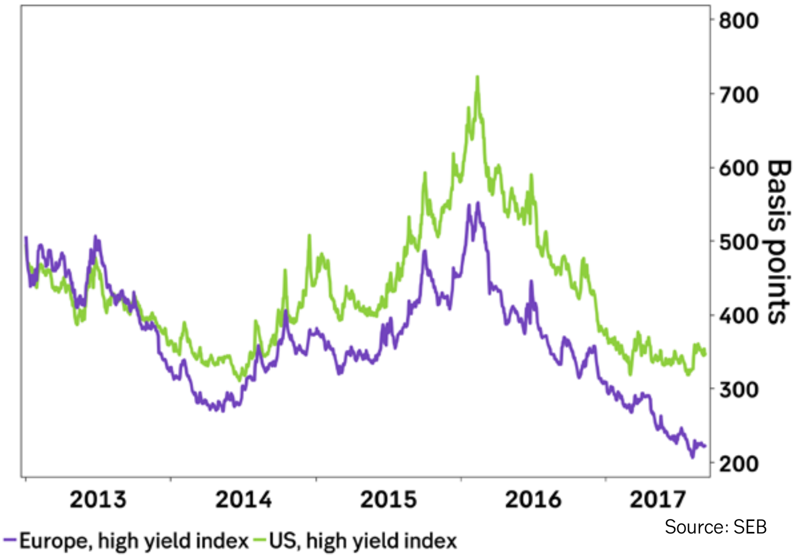
Emerging markets – EM debt

The outlook for emerging market economies has brightened, supported by higher commodity prices and a weaker US dollar. In the long term, this should strengthen current account balances as well as foreign exchange reserves. Political uncertainty and protectionism are also among the risks going forward, although fears about the effects of US President Donald Trump's policies have diminished somewhat. In the choice between investments denominated in USD and local currencies, we foresee advantages for investments in local currencies since there should be continued strengthening potential for a number of EM currencies.

Corporate bonds – Investment grade (IG) and high yield (HY)

Bonds in the investment grade segment have benefited from central bank bond purchases, but as such purchases are reduced, this effect will weaken. Reduced bond purchases and rising interest rates are to some extent an uncertainty factor for investment grade bonds, with their greater interest rate sensitivity than high yield bonds, which instead have a greater credit risk priced in. Since we foresee strength in the underlying economy followed by higher interest rates and yields, we see continued potential for high yield corporate bonds. The oil price recovery and the fact that the number of credit events has fallen substantially are other factors providing support for the high yield market.

LOWER RETURNS ON HIGH YIELD CORPORATE BONDS



Source: SEB

Because of strong macroeconomic data during the year, the trend has been favourable for corporate credits. Gearing looks set to fall in 2017 as a result of better corporate earnings, while the default rate is expected to decrease significantly during the year.

ASSET TYPE	TACTICAL EXPECTED YEARLY RETURN			RISK		
	SEK	EUR	USD	SEK	EUR	USD
Cash	-0.7%	-0.7%	1.2%	0.0%	0.4%	0.3%
Government bonds	-1.6%	-1.8%	-0.2%	1.8%	1.7%	3.0%
Investment grade (IG) corporate bonds	-0.2%	-0.2%	0.8%	3.2%	3.2%	3.2%
High yield (HY) corporate bonds	1.3%	1.4%	2.6%	5.9%	5.9%	5.0%
Emerging market debt*	5.8%	5.8%	7.8%	11.8%	11.8%	13.1%

Source: SEB

*Returns in local currencies

Alternative investments

Stable performance while awaiting volatility

In recent years, the calm expected during the summer months has been replaced by financial drama, which caused some nervousness this year before summer got under way. But compared to the storms over the Greek debt crisis in 2015 and the Brexit referendum in 2016, summer in the financial markets this year could probably be categorised more as a warm breeze. Historically low stock market volatility sustained by strong macroeconomic data, good second quarter corporate earnings, anticipated actions by the world's central banks and a stable trend in the commodity markets were all factors contributing to the summer lull this year. This environment proved favourable for both hedge funds and commodities. Both asset classes saw stable performance at an aggregate level, though with some exceptions.

Although the predictability of a positive economic trend combined with the absence of unexpected events provides fertile ground for increased risk appetite and indirectly leads to higher asset prices, predictability can also lead to "financial complacency". This complacency can cause investors to feel so secure in the economic environment that they let time act as the driver of returns rather than taking action themselves, in the form of increased investments. When this occurs, daily market movements tend to decrease and individual assets trade in ever narrower price ranges – volatility is lower. For some hedge funds, this situation is not a big problem, but for others, price differentials within and between various asset classes are an opportunity to generate returns. Given the low volatility of recent months, hedge fund managers have nonetheless done fairly well in their search for absolute return, although some strategies have been more adversely affected than others.

Equity long/short

The second quarter earnings season was different from previous seasons. The majority of corporate earnings reports exceeded expectations, boosting share prices, while shares of companies with weak reports were sold, lowering their prices. This clear gap in share price performance due to corporate earnings created good potential for fundamental hedge fund managers in equity long/short, since in this situation talented managers can generate returns in both their long and short positions. We believe that this situation, with investors opting for a more fundamental approach, should persist, which is why this strategy also has potential to perform well in the future.

Credit long/short

Given the improved macroeconomic picture this year, the trend has been favourable for corporate credits. The stronger economy has led to a significant decline in the number of credit events. This in turn has led to lower credit risk, narrowing credit spreads between corporate and government bonds and pushing corporate bond prices higher. The energy sector, which had been hit hard early last year by the steep fall in oil prices, has rebounded sharply, and companies that managed to navigate these difficulties are better equipped today than a couple of years ago. Because credit spreads are narrow today, there is marginal room for disappointing bond prices, which means that investors will need to monitor this trend closely going forward.

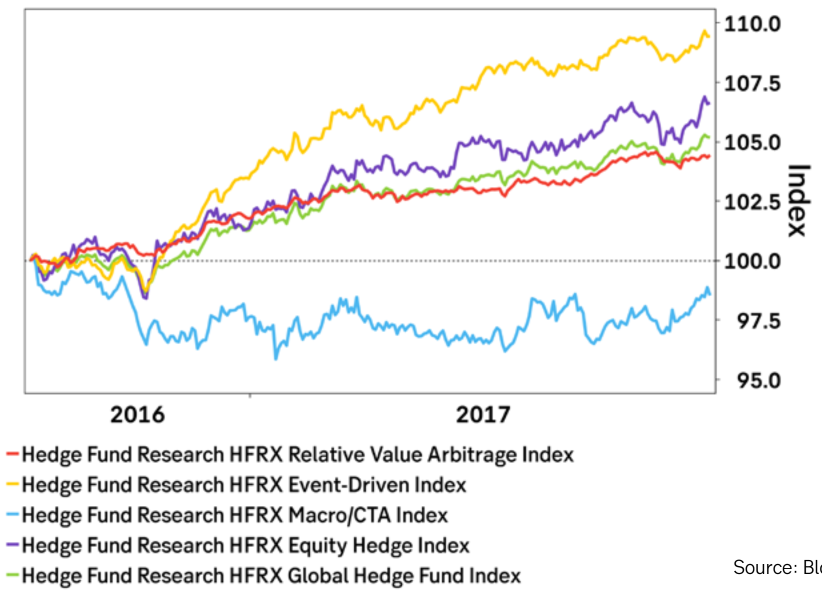
Event-driven

As noted earlier, fundamental factors have played a greater role in market movements during 2017. This has indirectly benefited the special situations sub-strategy, since the focus has increasingly shifted to the potential of individual companies rather than the stock market as a whole. Distressed credits are another sub-strategy that has benefited from improved conditions for corporate credits in general and the energy sector in particular. Given the brighter prospects for global economic growth and investors' continued fundamental approach to the market, event-driven strategies as a whole should continue to perform well.

Macro/CTA

Limited and trendless movements in the government securities market have been a stumbling block for both macro strategies and CTAs. Given the predictability of central bank actions, it has been possible for macro strategies to generate returns, though to a limited degree. For CTAs, the devastating trendlessness in the late spring has been offset somewhat by the prolonged weakening of the dollar. The imminent shift by central banks from stimulus to tightening should enable these strategies to generate dynamic return potential going forward.

SUMMER LULL BENEFICIAL FOR HEDGE FUNDS



Source: Bloomberg

Although low volatility can be hard for hedge funds to manage, this asset class showed strong performance during the quiet summer months. As a result, most strategies reached their highest index figures so far this year in late July.

Commodities

This year, the oil market has seen an artificial supply shortage as a result of production caps by OPEC+ (the Organisation of the Petroleum Exporting Countries plus mainly Russia), with falling global oil stockpiles and relatively stable oil prices as a result. We expect this situation to persist for a couple of years, although 2018 will be challenging for the oil market. This is both because we expect a sharp increase in US shale oil production due to the rising number of active oil rigs this year and because significant new production of conventional oil from outside the US and OPEC will reach the market as a result of previous investments. In 2019, we expect the oil market to have a natural supply shortage since no new production of conventional oil, or very little, will come into the market given the lack of investments in new projects over the past three years. This constitutes a challenge for US shale oil production – both to meet increased demand and to offset falling production of conventional oil.

We expect oil prices to be around 55 dollars per barrel (Brent) in 2018, and then rise to around 60 dollars per barrel in 2019. There is a potential risk of sharply declining prices if the OPEC+ agreement collapses. The rapid development of alternative energy resources may also affect the price trend. Risks of significant price increases are associated with whether the supply from Venezuela, which has already fallen by more than 15 per cent since 2015 due to underinvestment and political turmoil, will continue to decrease sharply and with whether Libya's resumed production will collapse again due to political turmoil.

Sharp price increases for metals

Metal prices rose sharply during the summer. Iron ore prices increased the most and are now almost 50 per cent higher than in June. This upturn is largely explained by increased demand and lower production in China. Because of the country's air pollution problems, steel plants have opted for high-grade imported ore over low-grade domestic iron ore. A campaign was also carried out to shut down production by aluminium smelters that lack government permits. There is also concern ahead of the approaching winter heating season (which begins in November) since – beginning this autumn – China may be forced to shut down production due to smog problems.

In addition to China's decreased production, the weakening of the US dollar has helped push metal prices higher. There is no shortage of metals such as iron ore and nickel, but there are currently some copper shortages due to strikes earlier in the year. We believe metal prices could continue to rise somewhat in the year ahead, but not at all as rapidly as during the summer.

Currencies

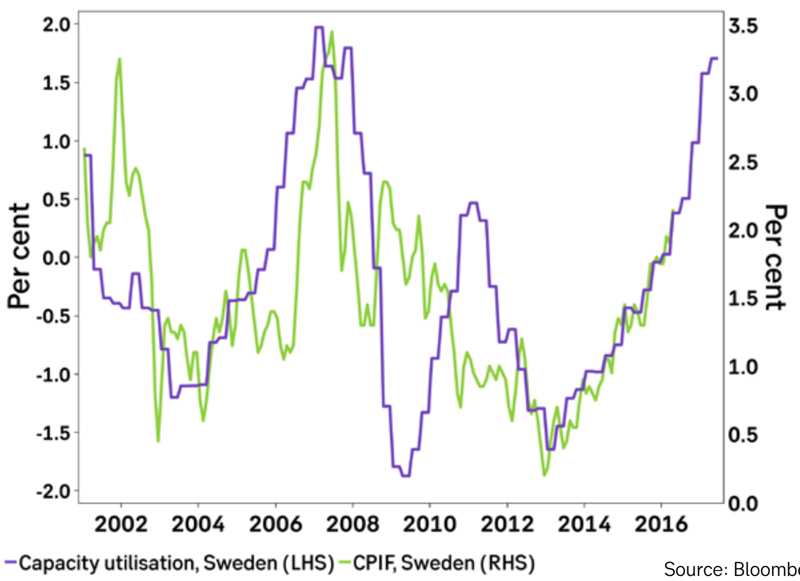
Short-term dollar rise in the cards

Political stability and a strong economic recovery in the euro zone have helped strengthen the euro. But a lower political risk premium does not account for all of the euro's appreciation against the dollar. The dollar's depreciation is also due to surprisingly weak US inflation, which has led the market to now expect only one interest rate hike from the Federal Reserve (Fed) through 2019. Geopolitical worries and weak risk appetite also seem to be hitting the dollar harder than before. However, we expect the Fed to continue its rate hikes, while the European Central Bank (ECB) will only gradually bring its unconventional monetary policy to an end. All in all, this means that the dollar will rebound, moving higher in the months ahead, also against the Swedish krona. However, in 2018 the krona will inevitably strengthen when Sweden's Riksbank hikes its key interest rate. The USD/SEK exchange rate will then fall towards 7.50.

This summer's dollar depreciation began as a euro rally after Emmanuel Macron's victory in the French presidential election reduced the political risk premium associated with the euro in recent years. The ECB has also started paving the way for a less expansionary monetary policy, with today's asset purchase programme (currently EUR 60 billion/month) gradually being phased out by mid-2018. We wrote earlier that global asset managers are under-weighted in euro assets, since political and economic crises in recent years have affected risk appetite and many investors have gradually sold their euro holdings. According to the International Monetary Fund (IMF), the world's central banks have the same euro allocation in their reserves today as when the euro was introduced in 1999, which is almost 10 percentage points below the level in 2008 (its peak allocation). If the European Union continues to show political stability and structural reforms, the percentage of euro holdings should gradually increase again. However, the dollar has fallen a bit far in the short term. Market expectations of the Fed are now very dovish, that is, investors believe there will only be one interest rate hike, while SEB's forecast is five successive hikes through 2019. The Fed will also start trimming its balance sheet this autumn.

The ECB will implement less expansionary monetary policy, but its first interest rate hike (in the deposit facility rate, paid to banks overnight) will not come until nearly a year from now. Since we believe that dollar depreciation is driven by speculative flows – with record-large positions for a higher EUR/USD exchange rate – rather than by fundamental changes, our view is that the dollar will rebound, moving higher against both the euro and the krona in the months ahead. In 2018-19, we believe the dollar will fall again and that the EUR/USD pair will then trade at well above 1.20.

BETTER GROWTH AND INFLATION HAVE NOT YET BUDGED THE RIKSBANK



Source: Bloomberg

In July, Swedish inflation (CPI excluding interest rates) exceeded the Riksbank's inflation target for the first time since December 2010. Combined with strong economic growth, this puts today's monetary policy of negative interest rates well past its sell-by date. However, so far the Riksbank remains focused on ensuring a sustained rise in inflation and countering krona appreciation.

The krona has appreciated considerably over the summer, and the fall in the dollar does not fully explain this movement. The krona is still seen as "a more volatile euro" by foreign exchange (FX) market players. Thus, if the euro strengthens, we usually also see the krona appreciate against what is already a stronger euro. That has also been the case this summer. The tailwinds pushing the krona higher are also an effect of very impressive economic growth in Sweden. SEB has long maintained an above-consensus growth forecast, and GDP figures for the most recent quarter clearly indicated that growth continues to be robust. Inflation will also be above the Riksbank's target during the coming months.

Pressure increasing on the Riksbank

The central bank's strategy has been to keep the krona weak in order to force up import prices, thereby boosting inflation. Above-target inflation undermines the argument in favour of continued Riksbank influence on the exchange rate. It also increases pressure on the bank to begin stepping back from its negative interest rates. Once it signals this, the effect will inevitably be a strengthening of the krona. The Riksbank is well aware of this, which makes the timing of its exit more difficult. Another reason why its policy change will be delayed until next year is that the Riksbank wants evidence that inflation has stabilised more sustainably around its target and that the increase is not just the result of temporary effects. When we look at our own currency flow measurements, we note that the robust data this summer have not tempted foreign players to buy SEK. On the contrary, foreign speculators have continued to sell the krona, which is surprising. The Riksbank's policy, which is partly aimed at maintaining a weak krona, has apparently gained credibility.

The weak dollar has adversely affected the Swedish stock market, especially industrial companies. This picture appears to confirm our view that many companies today have a high FX exposure – a low degree of currency hedging – which means that currency movements have a quick impact on earnings. The Riksbank's coming rate hikes can be expected to generate further currency flows, since it will also be less expensive to hedge currencies.

In the long term, we do not see the same potential for the krona as before. We recently raised our estimate for the EUR/SEK exchange rate for the next couple of years. The reason is that our calculations indicate a higher equilibrium rate for the EUR/SEK pair today than a few years ago, from 8.50 then to 9.10 today. One reason for this is that Swedish real interest rates are negative and Sweden's competitiveness has deteriorated due to the country's cost trend relative to its trading partners. We foresee the EUR/SEK rate falling to 9.00 but not lower in the year ahead. If the SEK strengthens to that extent, the trade-weighted krona, via declining dollar and pounds, is a factor that will restrict the Riksbank's potential to continue its interest rate hikes.

The **pound** will continue to be weak, and we see no possibility of an immediate appreciation towards more correct valuation levels (the GBP/SEK exchange rate will bottom out at just below 10.00 in 2018). The British economy will lag behind the rest of Europe, and Brexit negotiations with the EU will create uncertainty that will limit investor appetite for British assets.

The **Norwegian krone** will strengthen somewhat in the short term, but we do not rule out new tests below parity against the Swedish krona when the Riksbank raises its key interest rate in 2018. Expect the NOK/SEK pair to trade around 1.00-1.05 for a relatively long period going forward.

Finally, the **Swiss franc** has fallen faster than expected towards the levels our forecasts indicate for 2018. We believe an exchange rate of 8.00 is possible for the CHF/SEK pair in the year ahead, but we do not expect a return to levels of 6.00-7.00.

CURRENCY PAIR	EXCHANGE RATE				CHANGE IN EXCHANGE RATE, %	
	Now*	Q4 2017	Q1 2018	Q2 2018	Q4 2017	Q1 2018
EUR/USD	1.20	1.14	1.14	1.15	*-5.4*	*-5.4*
EUR/SEK	9.54	9.35	9.25	9.10	*-2.0*	*-3.1*
EUR/NOK	9.29	9.15	9.10	9.00	*-1.5*	*-2.0*
USD/SEK	7.92	8.20	8.11	7.91	*3.5*	*2.4*
USD/NOK	7.71	8.03	7.98	7.83	*4.1*	*3.5*
EUR/CHF	1.14	1.10	1.11	1.12	*-3.7*	*-2.8*
CHF/SEK	8.36	8.50	8.33	8.13	*1.7*	*-0.3*
EUR/JPY	130.8	131.1	133.4	136.8	*0.3*	*2.0*
GBP/USD	1.30	1.23	1.24	1.26	*-5.5*	*-4.4*
GBP/SEK	10.27	10.05	10.05	10.00	*-2.1*	*-2.1*

Currency forecasts were made by SEB Research & Strategy as of August 29, 2017. Please ask for a copy of our latest forecasts.

Theme – Energy efficiency

Vital to environmental targets, good for companies

The ice around the North Pole is melting. Sea level is rising 3 millimetres a year. There are water shortages in southern Europe, with a risk that the Mediterranean Sea shore will soon be a strip of desert. Greenhouse gases are affecting our environment and thus also our everyday lives. The emissions we have already produced will affect our planet going forward with a delayed impact. To slow these developments, the world has agreed on a new global climate plan.

Greenhouse gas (GHG) emissions from manufacturing, transport, consumption and other sources account for the rapid rise in temperatures. In 60 years, the Earth's human population has increased from 3 billion to about 7.5 billion. According to the United Nations, there will be about 9.7 billion people on the planet in 2050. With prosperity increasing, so too has energy consumption per capita. To meet these energy needs, we are burning more coal and oil, with global warming as a result.

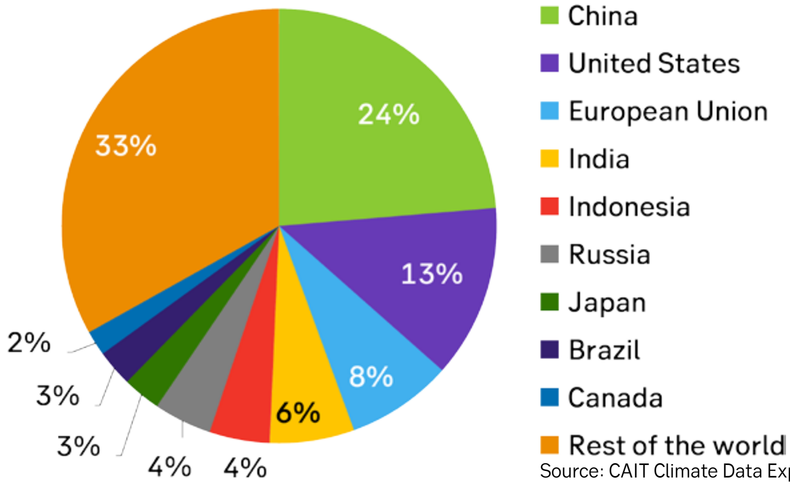
Reducing emissions is not just a matter of slowing down global warming; it is also linked to health and social stability. The air pollution on a bad day in Beijing, for instance, is equivalent to smoking two packs of cigarettes a day. Half the protests in China are related to environmental issues. Water shortages and harvest failures in southern Europe could lead to both food price inflation and migration. So it is also in the interest of local political leaders to curb GHG emissions.

In December 2015, 195 countries reached agreement at the United Nations Climate Change Conference in Paris (COP21) to reduce greenhouse gas emissions in order to limit global warming to 2 degrees Celsius by 2030. During the second half of the 22nd century, human activity should cause net zero GHG emissions. This ambitious plan consists of two simple components: 1) burn less coal and oil and switch to more environmentally-friendly energy sources, and 2) use less energy in general. The first component creates investment opportunities, for instance, in wind power (see "Wind power – A clean, economical energy source," *Investment Outlook*, June 2016), while the second provides opportunities for such devices as electric cars.

Focus on China and the US

More than 170 countries have already developed a plan for how they can limit their greenhouse gas emissions, and we have already started to see the results. According to the UN-affiliated organisation Climate Action, the number of planned coal-fired power stations was cut by almost 50 per cent in 2016. Of these 170 or so countries, the spotlight is on the two biggest emitters – China and the United States. China is investing increasingly in environmental protection, whereas President Donald Trump

CHINA – THE GLOBAL FACTORY



Source: CAIT Climate Data Explorer

Globally, China accounts for about one quarter of GHG emissions while the US and Europe account for 13 and 8 per cent, respectively. China's large share is due partly to its large population, but also to the fact that the West has shifted industrial production there. Measured as GHG emissions per capita, the average American emits 2.3 times more than the average Chinese or 2.6 times more than the average European.

has announced that the US will withdraw from the Paris climate agreement. However, a number of US states have said they will adopt these targets at the state level, so the effect of the president's decision is unclear.

Energy efficiency – one quarter of the target

A mix of energy sources consisting of more renewables and less fossil fuels is an intrinsic part of these plans, but more efficient energy use is one of the cheapest and most effective ways to limit greenhouse gas emissions.

It is a complex calculation to measure the amount of greenhouse gas emissions we have avoided due to energy efficiency, since changes in the energy mix, industrial mix and consumer behaviour of countries must be taken into account. However, the International Energy Agency estimates that, since the turn of the millennium, a full 13 billion tonnes of carbon dioxide (CO_2) has been avoided and more than a trillion dollars has been saved in expanded electricity production as a result of more efficient energy use. Based on the plans of the 170 countries, about 24 per cent of the reduction in greenhouse gas emissions will come from more efficient energy use, but to achieve the two-degree target, around 40 per cent will probably have to come from energy efficiency. There will thus be an increasing focus on energy efficiency.

By far the most important factor behind a more energy-efficient society has been regulation. In the US, automobile fuel efficiency requirements have gradually been raised since the 1970s, and in the 1990s a number of large countries and regions, such as the US, China and the European Union, adopted energy use regulations for refrigerators. Today about 30 per cent of all global energy use in areas such as lighting, cars, heating and cooling of buildings, household appliances and electric motors is regulated. In the West, economic growth (in terms of gross domestic product or GDP) has increased by more than 15 per cent since 2000. Meanwhile, energy consumption has fallen 5 per cent during the same period, thanks to energy efficiency. In emerging markets, GDP growth has nearly doubled, while energy consumption has not risen at the same pace due to energy efficiency in the manufacturing, agricultural and service sectors.

Although China is the world's biggest polluter today in terms of GHG emissions (the West's shift of production to China has contributed), the country has also made the most progress in energy efficiency. In 2014, China saved energy equivalent to Germany's entire production, and the country's latest five-year plan places great emphasis on renewables and energy efficiency, with the target being to reduce the country's

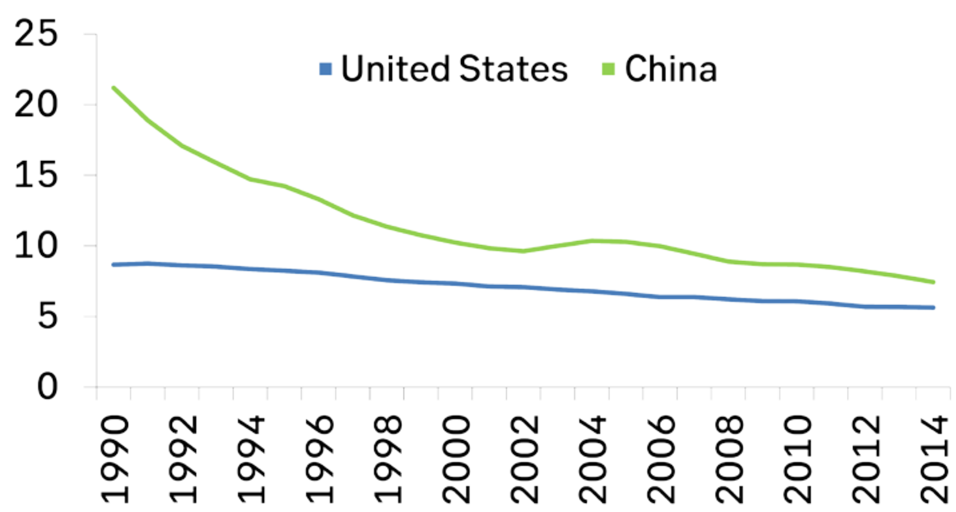
ENERGY – A REGULATED MARKET

Five different methods to improve energy efficiency:

- **Energy standards** – emission requirements, for instance, for petrol-powered engines and refrigerators
- **Mandatory energy savings targets** – requirements to reduce companies' average emissions over time
- **Labelling and information** – requirements for energy classification and labelling to raise consumer awareness
- **Financial incentives** – such as subsidies for electric cars
- **Financial disincentives** – such as petrol (gasoline) taxes

This text is based on the International Energy Agency (IEA)'s Energy Efficiency Market Report 2016, pages 17, 37 and 60.

ENERGY EFFICIENCY HAS IMPROVED FASTER IN CHINA THAN THE US IN RECENT DECADES



Source: World Bank

Energy intensity, measured as energy consumption divided by GDP, has shown a falling trend since the 1990s. Countries are thus producing more goods and services for the same amount of energy or less.

EXAMPLES OF NATIONAL PLANS

- **EU:** Starting in 2021, all new buildings are to be "nearly zero-energy buildings".
- **France:** Carbon dioxide tax on fuel for transport and heating will increase from EUR 56 per tonne in 2022 to EUR 100 per tonne in 2030.
- **Germany:** Is investing EUR 19 billion through 2020 in energy efficiency within areas such as recycling of waste heat, digital energy services for consumers and incentives to install more efficient heat pumps.
- **US:** As a result of updated commercial buildings standards, air conditioning must be 30 per cent more efficient by 2023 compared to 2010 standards. Proposals have been put forward for stricter GHG standards for heavy trucks corresponding to 2-2.5 per cent of the country's current oil consumption.

energy intensity (energy consumption divided by GDP) by 15 per cent between 2015 and 2020.

This is a complex equation involving a larger share of economic activity for the service sector (which uses less energy relative to manufacturing), introduction of more energy labelling standards, and funding for energy efficiency projects in construction and other industries. Because of its investments in environmental technology and energy efficiency, China today is the world's largest environmental technology market.

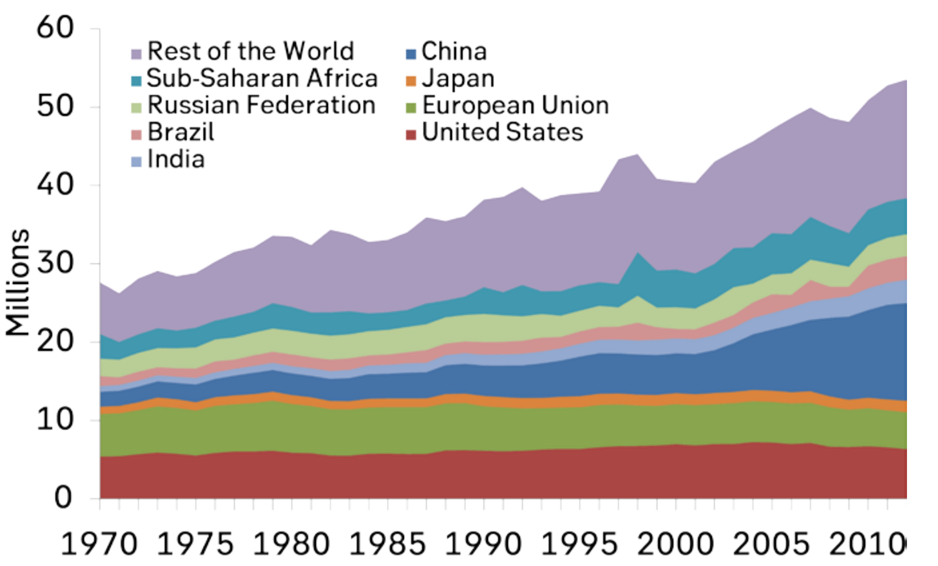
Opportunities for companies

New regulations also affect companies. As companies assume more responsibility for the environmental impact of their operations, there will also be a clearer link between energy efficiency, costs and earnings. Companies that have the most efficient production in terms of energy and materials or that have the least adverse impact on their local environment will have an ever-greater competitive advantage. Companies that install geothermal heat pumps, such as Swedish-based Nibe, will lower their customers' energy consumption significantly, while the risk of a higher carbon dioxide tax will affect traditional energy companies. Companies that can construct more energy-efficient buildings will benefit, as will suppliers of insulation materials such as the British-based Kingspan or LED lighting such as the Dutch giant Philips. Companies in energy-efficient air conditioning such as Japanese-based Daikin should have a good position in emerging markets.

According to various estimates, electric cars are twice as energy-efficient as petrol-fuelled cars (measured from the electric power station to the tyres, including factors such as energy waste in the electricity grid). This benefits leaders in the hybrid and electric market (see also "The car industry – A bright spot in Europe," *Investment Outlook*, June 2016) as well as their suppliers of components such as semiconductors (see "Semiconductors – The backbone of digitisation," *Investment Outlook*, December 2016). Another growing area is energy service companies, which help other companies to reduce their energy and resource use and are paid a percentage of cost savings.

Industrial motors and robots are also important areas. New, stricter standards for electric motors should affect both producers of robots and manufacturers that use them. Interestingly, robots programmed to perform more gentle movements can save up to 40 per cent energy (source: Chalmers.se, "Smooth robot movements reduce energy consumption").

CHINA ACCOUNTS FOR THE LARGEST SHARE OF GHG EMISSIONS



Source: World Bank

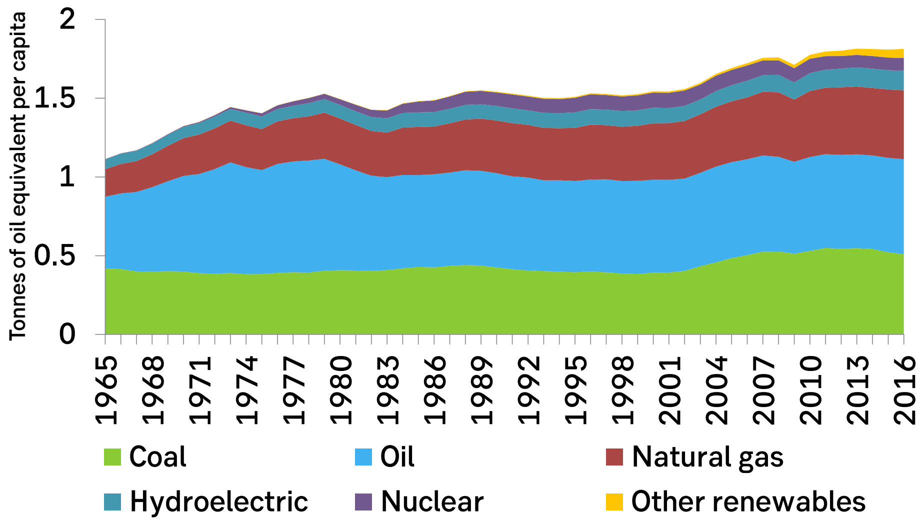
Total greenhouse gas emissions measured in thousands of tonnes. Emerging market (EM) countries, led by China, account for the largest share of the increase in GHG emissions, driven by population growth, industrialisation and the shift in production from developed to EM countries.

The long-term energy picture

How much energy we ultimately consume also depends to a large extent on energy prices. The lower energy prices are, the more energy we consume and the less important we think energy-efficient cars and other devices are. For instance, US sales of sport utility vehicles (SUVs) increased as petrol prices fell by 30 per cent in recent years. As a result, US petrol consumption per kilometre of driving has also increased even though cars have generally become more fuel-efficient. However, in Europe, where taxes account for 50-70 per cent of the final price of petrol, fuel consumption has continued to fall. Some experts believe that energy will become almost free, thanks to the sun and wind, which are unlimited energy resources. And regardless of our calculations, we will need more energy in the future – by 2050 there will be more than 9 billion people on the planet. We will consume more energy per capita – robots, faster computers and artificial intelligence will require ever more energy.

Meanwhile we face a great challenge in reducing our environmental footprint. In the long term, the solution is to switch from fossil fuels to renewable energy, but this is a slow and capital-intensive process (not just replacing power stations but also building new infrastructure). Energy efficiency is an important component in the equation to limit our emissions, especially during the transition phase over the next couple of decades. Countries and companies that embrace this challenge will benefit.

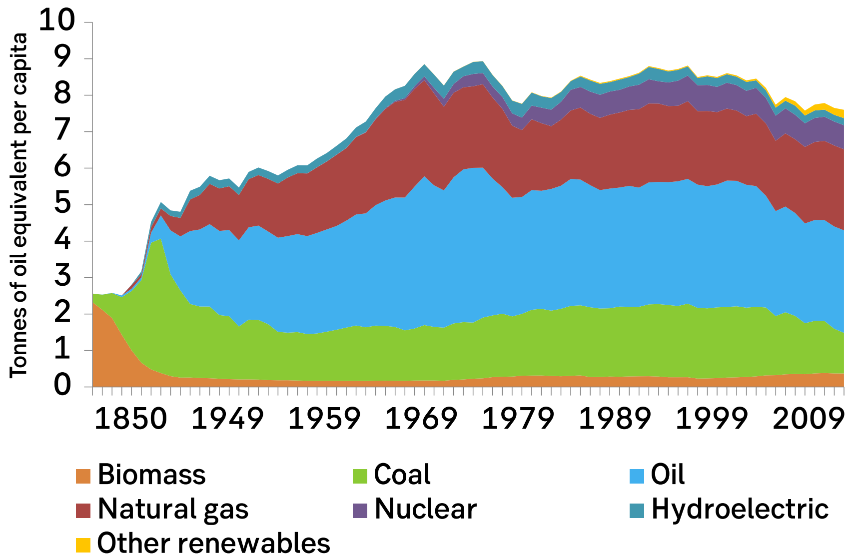
ENERGY CONSUMPTION PER CAPITA BY ENERGY SOURCE – THE WORLD



Source: BP Yearly Statistical Review 2017, UN, IEA, Bloomberg

From a global perspective, energy consumption per capita is on the rise and is still at levels like those seen in the US during the early 20th century. As prosperity increases, energy consumption per capita should also increase. We have also seen the share of coal and oil in the energy mix start to decline over the past seven years.

ENERGY CONSUMPTION PER CAPITA BY ENERGY SOURCE – US



Source: US Census Bureau, EIA, Bloomberg

It is quite apparent how the US economy shifted from charcoal (biomass) and coal. Energy consumption per capita has seen a falling trend in the 21st century, but some of this is due to the relocation of energy-intensive production abroad. Just as wood and coal have declined in importance, oil should also become less significant, and the share of renewable energy should increase in both absolute and relative terms.

Theme – The private loan market

Investments in a low interest rate environment

The current environment of extremely low interest rates makes it difficult to generate returns on interest-bearing assets. To find good investment opportunities, you need to take risks and in some cases be prepared to give up liquidity by making investments with longer lock-in periods. If you are willing to accept this, our assessment is that the private loan market offers good opportunities for attractive value generation.

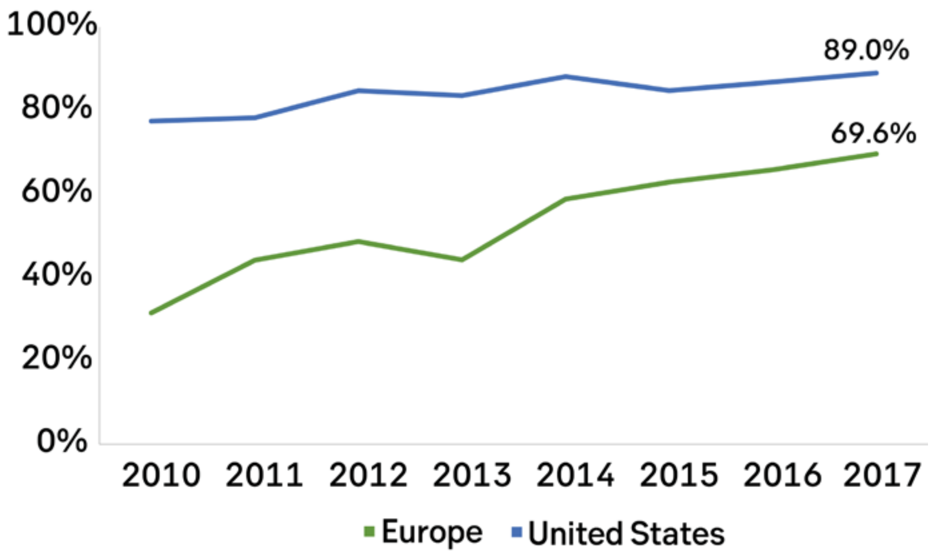
Today the return on traditional fixed income investments such as government bonds is low or even negative. Meanwhile an increase in market interest rates could further worsen such returns. Thus other types of fixed income investments, which are partly affected by other market factors, are attractive. The flexibility to be able to actively adjust both interest rate risk and credit risk is becoming increasingly important.

One attractive alternative is the private loan market, which offers relatively high expected returns and meanwhile has a limited co-variation with the stock market, for example. The credit risk is comparatively low, since this kind of loan is the one that is paid back first if a company has financial problems, while the number of credit events over time is lower than for high yield corporate bonds. The interest rate risk also looks different, since many of the loans have a variable coupon rate. This reduces risk in times of rising interest rates, making the private loan market attractive for diversification in an investment portfolio. Since 2016 there has been a new European Long Term Investment Fund (ELTIF) regulatory framework, which also allows non-institutional investors (with certain restrictions) to invest in the private loan market – a market that is otherwise difficult to access.

The private loan market is growing

Global loan markets have changed since the period before the financial crisis, resulting in attractive investment opportunities in private market loans. Banks have reduced their lending to companies, due to ever-stricter capital adequacy requirements. This has led to attractive opportunities for investors in private market loans, in which companies have instead turned to private lenders. In recent years this has created business opportunities for institutional lenders that are not covered by the same rules as traditional banks. Regulation will affect markets in the future as well. This dynamic will enable private market loans to continue taking away market share from traditional bank lenders.

PRIVATE LENDERS ARE INCREASING THEIR SHARE OF THE CORPORATE LOAN MARKET



Source: S&P LCD Global Review US/ Europe Q2 2017

Private lenders in Europe (outside the banking sector) have increased their share of the primary loan market from 32 per cent to 70 per cent from 2010 to 2017. In the US, this figure rose from 77 to 89 per cent during the same period.

Advantages compared to the high yield market

The high yield corporate bond market is not accessible to all borrowers, especially those that need more unique financing. Some companies are too small to be able to issue bonds to the public. They can instead obtain more flexible capital solutions via the private loan market. Because the loans are private, information about them need not be provided outside the private lender group. The private loan market offers individually tailored funding that can be used, for instance, in leveraged buy-outs or to finance the expansion of operations to new countries. Examples of such funding are illiquid loans to private equity-owned companies, but also loans to publicly traded companies or loans for infrastructure and other construction projects. The loans are set up directly between a lender and the borrowing company. Analyses are of the greatest importance when investing in the loan market and include credit analyses, meetings with company executives and site visits. It is also important to have a local presence in markets where an investment occurs. Despite thorough analysis and good risk diversification, it may happen that borrowers cannot pay interest during the life of the loan or repay the loan principal.

Lower credit risk for senior secured loans

Credit risk is the risk that a borrowing company cannot pay interest during the life of the loan or repay the loan principal due to default. Credit risk is often lower in the private loan market, since it largely consists of "senior secured loans": loans with high priority, for example in case of default. Such lending is secured by the assets of the company and is thus among the capital that is repaid first by the company in the event of a loan loss. In a default situation, the degree of recovery is often higher for these loans than for corporate bonds issued by the same company.

Senior secured loans make financial demands on the borrower, including restrictions on the sale of assets and on assuming further debts. These obligations increase the disclosure and reporting requirements for companies, enabling the lender to spot any problems at an early stage.

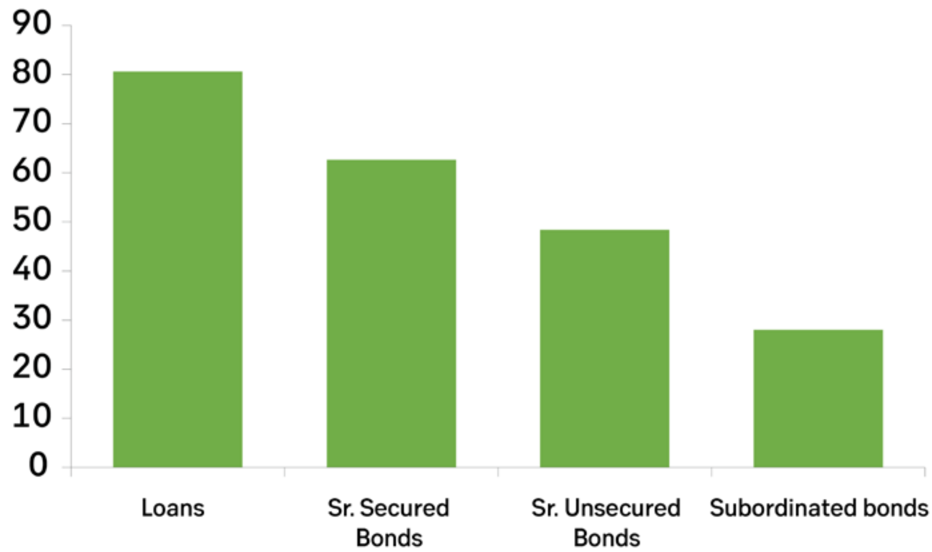
Floating interest rates are attractive

Interest rate risk is the risk that interest rates will go up while you hold a fixed income investment. When interest rates go up, the price of existing fixed income investments may fall. However, interest rate risk can be reduced by holding a large proportion of the portfolio in floating rate notes (FRNs). Private market loans are mainly FRNs that have a floating interest rate (coupon), which is usually adjusted every three months. This leads to a low interest rate risk because the interest rate is continuously reset. When adjusting, the coupon is set at a given base rate (for example EURIBOR) plus a fixed credit premium. FRNs are thus influenced only by short-term market interest rates and the credit premium. The effect is that the investor takes a credit risk, but is protected against rising interest rates and yields. If short-term market rates go up, this is actually favourable since the total coupon rate on the loan gradually rises. This is different from high yield corporate bonds, which ordinarily offer a fixed coupon to the investor. Considering today's low interest rates and the forecast of rising interest rates as central banks ease their expansionary monetary policies, floating rate loans will be favoured.

Giving up liquidity

Giving up liquidity is one alternative in order to generate returns in the prevailing low interest rate environment. Being able to sell quickly and receive payment for a security is, in itself, a source of security and

GLOBAL AVERAGE RECOVERY RATE FOR LOANS IN CASE OF DEFAULT



Source: Moody's Corporate Default & Recovery Rates February 2017

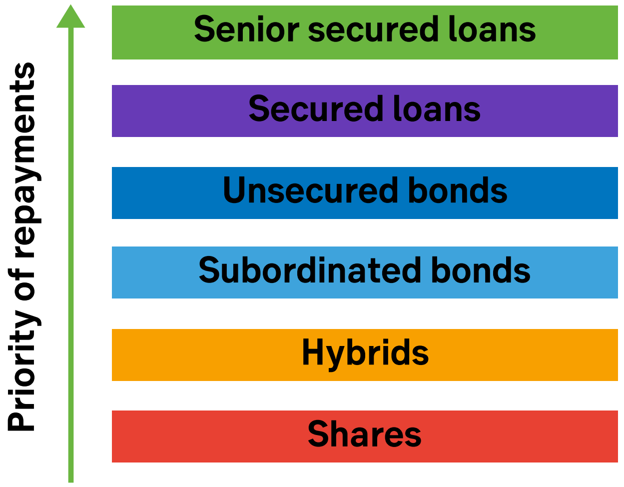
The average recovery rate for private market loans is 80 per cent in case of defaults. In a default situation, the degree of recovery is often higher for these loans than for corporate bonds issued by the same company.

decreases the risk in an investment. But some securities and forms of investment, such as the private loan market, require locking in capital during a lengthy period, since the liquidity in underlying markets is limited. The liquidity risk is consequently higher in this type of investments, and this is offset by investors often demanding a higher return. Private loan market funds are being created in order to offer attractive, diversified investments in companies whose loans have limited liquidity.

In a world of historically low interest rates, the alternatives for attractive fixed income investments are limited. The private loan market is one possible way to go in order to receive what we regard as good risk-adjusted returns.

A loan fund set up according to the new ELTIF regulations also allows certain non-professional investors to participate in this market, which is otherwise difficult to access.

SENIOR SECURED LOANS ARE AT THE TOP OF THE CAPITAL STRUCTURE



Source: BondAdviser

Private market loans are secured by the assets of the borrowing company and are thus among the capital that is repaid first by the company in the event of a loan loss.

Contributors to this issue of Investment Outlook

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

Henrik Larsson
Portfolio Manager
henrik.y.larsson@seb.se

Esbjörn Lundevall
Equity Strategist
esbjorn.lundevall@seb.se

Kai Svensson
Portfolio Manager
kai.svensson@seb.se

Louise Lundberg
Economist
louise.lundberg@seb.se

Reine Kase
Portfolio Manager
reine.kase@sebgroup.lu

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

Johan Hagbarth
Economist
johan.hagbarth@seb.se

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

Carl Hammer
Chief Currency Strategist
carl.hammer@seb.se