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Investment Outlook

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Introduction

Late-cyclical phase is still sustainable

In line with our expectations, financial markets have been erratic and turbulent so far during 2018. Last year's markets were unusually calm and robust, making the prevailing volatility logical in the late-cyclical phase that we are now experiencing. In this situation, it is important to form an opinion about how much longer the current expansion can reasonably last and how other investors may conceivably behave based on this estimate. Since February, markets have undergone a downward correction, followed by a consolidation phase during which many investors reduced risk in their portfolios by decreasing their proportion of equities and corporate bonds as well as their proportion of cyclical exposure. The question today is whether this was a first step towards a successively more defensive attitude, or whether it was much-needed profit-taking during a continued positive trend.

If we study global stock and corporate bond market indices, it is obvious that investors are hesitating. The price gains on many asset classes are at around zero this year. From a Swedish perspective, however, our portfolios have received an extra boost from the weak krona, which has helped to fuel the Swedish stock market and has also enabled investments traded outside Sweden to show a good performance when converted to SEK.

So far during 2018, we have been moderately overweight in risk assets, such as equities and corporate bonds. We are sticking to this position, since we foresee a prolonged favourable expansion, during which a decline in central bank stimulus measures will slowly cool economic growth. We also expect a healthy but gradually flatter pace of corporate earnings increases in the coming year. As usual, there are a number of threats and risks, implying that higher volatility is here to stay. The late-cyclical phase, combined with higher volatility, suggests that we will have more varied risk exposure ahead.

One way of allocating risks is to find areas with their own structural driving forces that do not follow the global economic cycle. The Indian economy is one such example, since it is undergoing a transformation with its own underlying drivers. We delivered an optimistic analysis about India in this publication three years ago. Now it is time for an update. In this issue we present our view of the outlook for India and its capital market, which remains bright.

Wishing you enjoyable reading.

Fredrik Öberg
Chief Investment Officer
Investment Strategy

Risk exposure & allocation

An economic cycle is the period it takes for the economy to undergo both an upturn and a downturn. Defining where in the economic cycle we are is very important, since it affects the level of risk exposure in our portfolios.

Cyclical phase	Growth	Infla-tion	Best asset class	Best equity sector
Phase I Stabilisation	⇩	⇩	Bonds	Defensive growth
Phase II Recovery	⇧	⇩	Equities	Cyclical growth
Phase III Expansion	⇧	⇧	Commodities	Cyclical value
Phase IV Downturn	⇩	⇧	Cash	Defensive value

The above table shows an economic cycle model and indicates which asset classes normally perform especially well during each respective phase.

We are in a phase where the pace of growth and inflation is rising or has risen, indicating that we are in the latter part of the economic upturn. In this phase – Phase III – central banks usually step in and slow things down by means of higher key interest rates. But today, at an aggregate global level, it is more a matter of central banks trying to normalise key rates and bring an end to stimulus measures. Combined with a global capital spending cycle that is fairly young, and given such a healthy and broad-based growth rate, we believe that both the economic cycle and the earnings cycle will last longer than many observers are expecting.

It would thus be too cautious to recommend a clearly defensive portfolio today, but the late-cyclical phase we are in – combined with higher expected volatility – suggests that we will have more varied risk exposure ahead.

The following is a review of a number of important factors that justify our continued moderately optimistic view of risk assets and how these factors may influence future developments.

Growth and corporate earnings

Leading indicators have declined from high levels. This was expected and does not change our forecast of a global economic growth rate of around 4 per cent this year and next. Inflation has climbed but is expected to level out at around its current 2 per cent. With extra help from the American tax reform, we expect global corporate earnings to rise by more than 10 per cent this year and around 10 per cent next year. Developments will vary considerably between different regions, mainly due to exchange rate effects and sectoral structure.

Central banks

We expect the US Federal Reserve (Fed) to hike its key interest rate three more times in 2018. The Fed 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, and the net effect of their actions on liquidity is expected to be positive, but noticeably less so than before. The breakpoint may occur as early as this September, when the European Central Bank (ECB) may end its stimulative bond-buying. Sweden's Riksbank continues to pursue a highly expansionary monetary policy. Overall, the outcome may be continued rising interest rates, which will increase risks since global debt is at a high level.

Valuations

This year's weak markets, combined with wider spreads between corporate and government bond yields as well as rising corporate earnings, have led to falling asset prices. Pricing is still high compared to the historical average and is an effect of low interest rates and yields. If the economic expansion proves persistent, today's pricing may very well endure. Share prices may thus keep pace with corporate earnings generation.

Risk appetite and positioning

Risk appetite and positioning generally go hand in hand with valuations when the world is in the latter part of an economic upturn, which is also true this time around. Valuations are relatively high, and investors with high risk appetites have aggressive portfolios, but to a clearly lesser extent than at the beginning of 2018.

Expected returns

We expect positive returns for most asset classes over the next 12 months, except for traditional fixed income investments. These expected returns are lower than historical averages, while risk is unchanged. Such forecasts are dependent on our optimistic economic outlook proving correct.

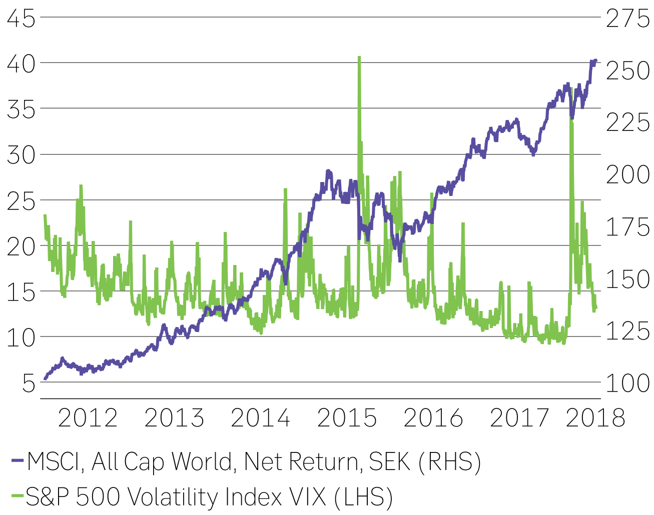
Examples of risks

A downturn in the economic cycle would have a major impact, but the recession risk is low. Valuations are high from a historical perspective. After their major liquidity injections and record-low key interest rates, we expect central banks to gradually normalise policies, which means that a large stimulative force will diminish. A surprising inflation surge may push interest rates further upward than expected. Global debt is high. We see signs of weaker home prices here and there. Risks of possible trade barriers have also emerged.

Asset class allocation

We are choosing to remain moderately overweight in equities and corporate credits. This implies an overweight in global equities, a neutral position in Swedish equities and alternative investments, and an underweight in fixed income investments. We are aware of the prevailing late-cyclical phase and are prepared to make adjustments. In global equities, we have minor regional and sectoral divergences from indices, implying that company-specific risks predominate. Corporate bonds with short maturities still comprise most of our fixed income portfolios, while our alternative investments are dominated by a relatively defensive hedge fund portfolio.

Global equity index and share price volatility



Source: Bloomberg/Macrobond

The chart shows returns on the broad MSCI All Country World Index, calculated in SEK, and volatility in the S&P 500, a broad US equity index.

Equities

- International share prices are treading water, but a weak krona is leading to strong returns for Swedish-based investors.
- "New-generation" companies in the technology and consumer sectors are dominating developments.
- A very strong first quarter report season in the US and an acceptable one in Europe.
- Falling international equity valuations, due to worries about the economic cycle and trade wars.
- Upbeat economic statistics in Sweden, combined with high Nordic corporate earnings. Probably more lukewarm economic performance ahead.
- A levelling-out of Nordic equity returns after more than a 220 per cent total return since 2009.
- Wide variations in Nordic corporate earnings are providing investment opportunities.

Return expectations, next 12 months

	Return	Risk
Global equities	7.0	12.6
Emerging market equities (local currencies)	9.5	14.3
Swedish equities	8.1	12.6

Source: SEB

Fixed income investments

- The Riksbank's first rate hike seems likely to take time.
- The end of loose European Central Bank policy is approaching.
- The US Federal Reserve will raise its key rate to 3 per cent in 2019.
- Global bond yields will slowly rise.

Return expectations, next 12 months

	Return	Risk
Government bonds	-1.1	1.7
Corporate bonds, investment grade (Europe IG)	0.9	3.2
Corporate bonds, high yield (Europe HY)	3.0	5.2
Emerging market debt (local currencies)	4.0	11.1

Source: SEB

Alternative investments

- Longed-for volatility is back with a vengeance.
- Fewer divergences in performance between hedge fund strategies.
- Stable trend for equity long/short – these conditions are likely to persist.
- Clear central bank guidance and variations between regions are providing the basis for macro strategies.

Return expectations, next 12 months

	Return	Risk
Hedge funds	3.5	6.0
Commodities	3.1	11.8

Source: SEB

Market view – macro

Capital spending is driving growth

The growth cycle is moving forward, though with temporary weakness early in 2018. Late-cyclical drivers such as strong labour markets and rising capital spending suggest continued healthy growth both this year and next. Political drama will cause concerns but probably not hamper growth. Inflation will climb, but only a bit. So the fundamental outlook remains bright, but this late in the economic cycle the question is how long it can last. This discussion may fuel worries that affect the financial market climate, especially in stock markets.

In the last issue of *Investment Outlook* we portrayed a world economy in a phase resembling a mature economic expansion. Since then we have received economic data that were a little weaker than expected, such as first quarter American GDP and various European economic indicators that fell somewhat from stable levels, but we regard this reversal in macroeconomic strength as temporary. Growth is continuing and is now driven increasingly by traditional late-cyclical forces, such as strong labour markets and rising capital spending.

This late-cyclical picture is most clearly noticeable in the United States, which is setting the pace. The US labour market remains unusually strong. Unemployment has fallen to 3.9 per cent. This is well below 4.5 per cent, which the Federal Reserve views as equilibrium unemployment – the level below which labour shortages will drive faster pay increases and inflation. Even though joblessness has been lower than this level for some time, pay increases have only accelerated marginally. We expect unemployment to keep falling, accentuating labour shortages (which in themselves hamper growth) and causing some acceleration in the rate of pay increases (which drives up inflation). A strong labour market, combined with rising share prices and higher home prices, suggests healthy growth in private consumption. Steadily rising capacity utilisation also generates a greater need for business investments. Capital spending is now emerging as an important driver behind our optimistic growth forecast for 2018 and 2019. Capital spending leads to rising growth as it occurs, but it also leads to improved future growth potential, since it makes higher production possible. Fiscal stimulus, especially after the recent tax reform, will contribute further to a continued bright growth outlook in the US.

In Europe, future growth will also be driven by rising capital spending and private consumption, but from relatively low levels. Exports will also make a positive contribution to growth, despite a stronger euro. Fiscal stimulus will mainly contribute via reform spending by the new German governing coalition.

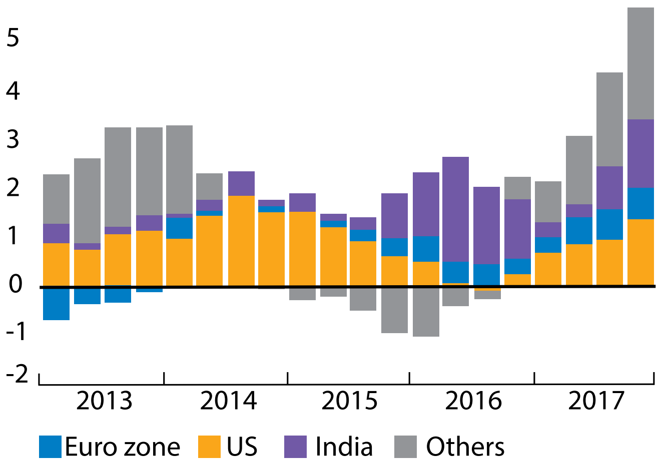
For emerging market (EM) countries, the fundamental outlook also remains bright, although as elsewhere in the world, economic statistics included some temporary disappointments early in the year. Rising US interest rates and a strong dollar have historically made observers worry about negative effects on EM countries and their financial markets, since these countries have often had large dollar-denominated loans. But if we look at historical events, such worries have not always been justified. When the US hiked its key rate in 2004-2006 all EM assets climbed, in keeping with the pattern that healthy global growth and high risk appetite drive EM growth and capital inflows. We expect continued slowly decelerating economic growth in China – the largest country in the EM sphere – driven among other things by the Beijing government's focus on debt reduction. In India, growth will speed up again from already healthy levels, while Russia will experience decent growth with the help of higher oil prices but will be held back by Western sanctions.

The overall growth outlook for the world economy is very good, both for this year and next. The growth dynamic provided by private consumption and capital spending has historically been capable of surprises, both in strength and longevity, which supports our forecast. But what will happen after that? How long can the upturn last? And what are the risks to our main scenario?

The current expansion is on its way to becoming the lengthiest in modern times (see right-hand graph, page 8), assuming that our forecast proves correct. Contrary to what some observers fear, in itself this is no reason for it to end. Compared to all previous post-war upturns, growth has also been slower this time around, which suggests greater longevity. High world debt levels are worrisome, but at present we are not seeing any clear signs of bubbles big enough to trigger a global recession.

Long periods of expansion usually also lead to more creative explanations making the rounds. In the 1990s, there was talk of a "new economy" that would lead to higher productivity and thereby justify higher share prices. In the years before the Lehman Brothers crash of 2008, the concept of "the great moderation" arose, in which such factors as globalisation would eliminate cyclical fluctuations: some spoke of a "super cycle". In both cases, these forecasts proved disastrously wrong. Obviously it is risky to draw such conclusions.

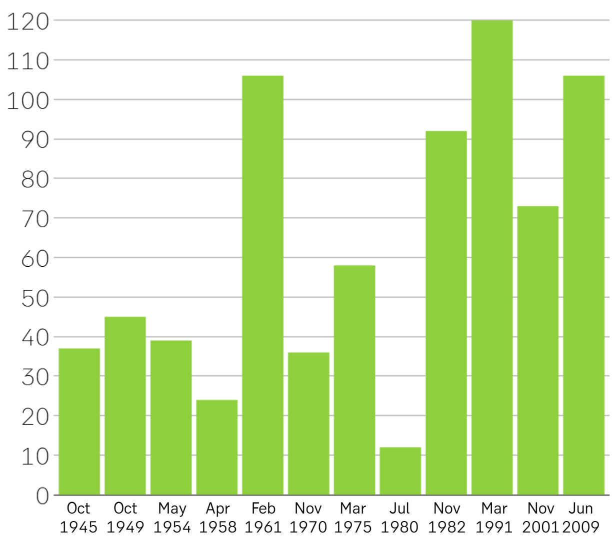
Capital spending driving growth



Source: OECD

The chart shows how selected regions have contributed to capital spending growth (in percentage points). In a mature upturn phase of the economic cycle, capital spending normally surges, as it is doing this time around. This is an obvious growth engine and thus positive in the short term. Looking ahead, the picture will be more ambiguous. Investment booms have historically often been followed by weak growth.

Upturn approaching longevity record



Source: NBER

The chart shows the number of months that economic upturns have lasted, from their starting month. The ongoing economic upturn in the US (bar at far right) has now lasted for nine years. In the summer of 2019, it will break the longevity record, according to our forecasts. Stimulus measures by central banks and clearly slower average growth than during the previous record-breaking expansion are contributing reasons.

This time around, some economists argue that as a result of digitisation and robotisation, we are facing a fourth industrial revolution (the first three being the steam engine, electrification and computerisation). How big the long-term impact will be remains to be seen, but technological advances are certain to influence investors and decision makers ahead.

Looking at more traditional factors, two principal areas have the power to influence future growth: political events and traditional cyclical forces in the economy.

In politics there are several forces that may influence the economy: everything from the Brexit process and the European Union's integration efforts to the new roles of Russia and China in the global community and Donald Trump's impact on international relations. Our main scenario is that both a trade war with China and a serious escalation related to the Iran issue can be avoided, although the latter is contributing to oil price increases – which we expect may continue for a while. Historical experience tells us that political events rarely have a major impact on the growth picture, which may prove correct this time too. As a result, cyclical forces will be crucial to long-term growth.

Cyclical forces such as capital spending needs and private consumption suggest continued healthy demand. But is there enough supply to meet demand? Can this happen without driving up inflation and interest rates so much that they stifle demand? Capital spending in itself helps expand the supply side, and companies have not yet hit their production ceiling either. However, increasing labour shortages may become a bigger problem, which might eventually hamper growth. Aside from capital spending, this phase of the economic cycle also usually attracts productivity-raising measures, which probably have the potential to stimulate supply. Although inflation has risen somewhat, we do not foresee sharp upturns. Pay increases have been modest so far. This trend may persist, since globalisation and robotisation are likely to hold back pay demands. The actions of central banks are also keeping interest rates low.

The near-term outlook thus appears robust, but in the coming quarters more and more observers are likely to discuss downside risks. We believe that supply-side restrictions will eventually push down growth. It is tempting to forecast a "soft landing". Unfortunately this is a process that has rarely materialised historically. A more likely scenario is a more significant deceleration some time past next year. There is a risk that such a scenario may arrive earlier, for example due to rising inflation. Another risk in our forecast – but on the upside – is that technological advances and productivity gains will enable growth to become faster and/or even more long-lasting, but our main scenario is a deceleration after 2019.

GDP forecasts, year-on-year percentage change

Market	2016	2017	2018	2019
US	1.5	2.3	2.8	2.5
Japan	0.9	1.7	1.2	1.0
Germany	1.9	2.2	2.4	2.1
China	6.7	6.9	6.6	6.2
United Kingdom	1.9	1.8	1.2	1.6
Euro zone	1.8	2.4	2.4	2.3
Nordic countries	2.2	2.3	2.4	2.3
Baltic countries	2.2	4.3	3.4	3.1
OECD	1.8	2.5	2.5	2.3
Emerging markets	4.4	4.8	5.1	5.1
World, PPP*	3.2	3.8	4.0	3.9

Source: OECD, IMF, SEB * Purchasing power parities

Global equities

Strong earnings, but worried investors dominating 2018

For Swedish-based investors, global equity portfolios have performed very well this year, but virtually all their returns since the beginning of this year have been attributable to the weak krona (SEK). In 2017 the exchange rate effect was the opposite. So far during 2018, a global equity index in local currencies is largely unchanged, despite a strong first quarter report season. Worries about trade wars and rising long-term US Treasury yields, as well as regulation of the IT sector, are among factors that have hampered stock market performance.

Last year's winner was the emerging market (EM) sphere, with an upturn of 24 per cent in Swedish kronor. Early in 2018 this trend looked set to continue, but higher US long-term yields and a rising US dollar have often had an adverse effect on EM assets – this time, too. So far in 2018 the EM equity index is up 6 per cent while share prices in Europe, the US and Japan are up 7-8 per cent, in SEK terms.

Favourable report season

New-generation companies continue to dominate the stock markets. They are mainly in the information technology (IT) and durable goods sectors. IT is continuing its victory march and is the best-performing sector this year too, gaining about 15 per cent, while durable goods are up 11 per cent.

After 70 per cent of US-based IT companies had reported their quarterly results, sales growth stood at 15 per cent and earnings growth 30 per cent, compared to the same period last year. Facebook, which has recently faced media headwinds, nevertheless scored 49 per cent sales growth and 62 per cent earnings growth. For Google (known in the stock market as Alphabet), the corresponding figures were 23 and 28 per cent. Amazon and Netflix – two consumer-oriented companies with modern business models – reported sales growth of 43 and 40 per cent, respectively, and earnings growth of 120 and 60 per cent, respectively. Such impressive figures are hard to find among more traditional companies. But earnings multiples scare investors in some cases, and in other cases they do not. Amazon and Netflix shares trade at price/earnings (P/E) ratios of 78 and 98, respectively, based on 12-month forward-looking earnings. This imposes heavy demands on future growth and profitability. American IT giants have relatively low valuations, though. Facebook and Google are priced at 21 times earnings, Apple at 16 times earnings. These three IT companies also have net cash equivalent to 10-15 per cent of market capitalisation. This is being used, among other things, for share buy-backs. In its quarterly report, Apple announced a USD 100 billion buy-back programme, which naturally helps keep Apple shares up. Despite the share price upturns of recent years, it is hard not to be optimistic about the IT sector, given its valuations and structural growth.

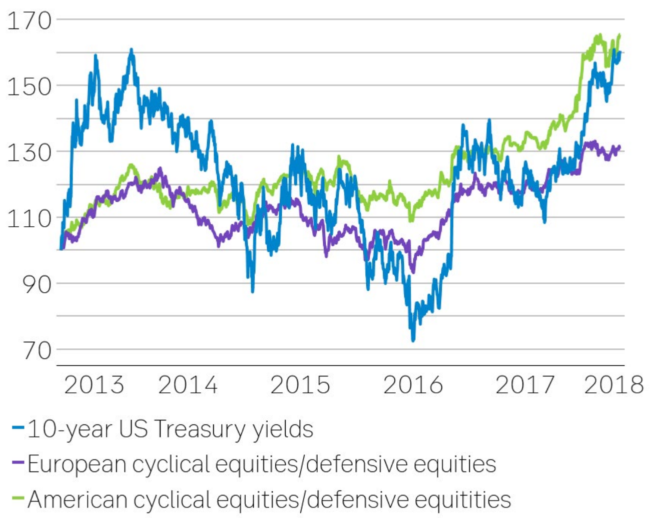
Of the more traditional sectors, oil is up 12 per cent thanks to rising oil prices. The worst performing sector is non-durable goods (including convenience goods and household products), which is struggling against costs and competition from new market players, leading to squeezed earnings. Telecom operators and real estate are two sectors that are generally highly leveraged; they have thus fallen this year due to internationally rising interest rates and yields.

The earnings of companies in America's broad S&P 500 equity index were up 24 per cent in the first quarter, while sales growth was 8 per cent. This was the first quarter of the new US tax law, and its direct positive impact on earnings was estimated at about 8 per cent. The tax reform has also led to indirect effects such as higher capital spending, accelerated share buy-back programmes, new hiring and increased compensation to employees.

The European report season did not show the same impressive growth numbers, but earnings were 4 per cent and sales 1 per cent above expectations. Given the strong EUR during the first quarter, the euro zone report season was acceptable. In emerging markets as a whole, the quarter did not offer any major surprises. Asia generally provided more upside surprises than Latin America.

Commodity companies are doing well, thanks to price increases. Industrials are delivering solid figures. The banking sector is struggling with costs and tighter legal requirements, which has made earnings growth difficult. European banks carry comparatively low valuations, but we cannot expect any major earnings growth as long as interest rates are close to zero. Key interest rate hikes by the ECB would be a positive factor that would push earnings higher. But according to current market forecasts, we will have to wait another year for these. European banking executives are undoubtedly casting a jeal-

Cyclical shares doing better than defensive ones



Source: Bloomberg/Macrobond

The chart shows the relative performance of cyclical vs non-cyclical companies in the US (green) and Europe (purple). The blue curve shows 10-year US Treasury yields.

P/E ratios in global equity index have fallen

Source: Bloomberg/Macrobond

Valuations on the MSCI All Country World Index of equities has fallen, contributing to our optimistic view of equities as an asset class since share valuations are lower than before.

ous eye towards the US, where the banking sector seems to be enjoying a better environment – with higher interest rates, a new tax reform and the possibility of some deregulation if the Republican Party gets its way.

On a global basis the earnings trend is thus favourable. This is completely in line with strong underlying economic growth. Cyclically sensitive companies are enjoying good volume growth and have strong pricing power. In other words they can raise prices without greatly affecting demand, which promises continued healthy earnings performance. In contrast, defensive companies – which are not cyclically sensitive – have found it harder to generate earnings. This is because underlying cost pressures are rising, while demand is not increasing to the same extent. Companies try as much as possible to pass on their costs to customers, but the outcome is usually that they have to sacrifice margins. The pattern in stock markets is clear – cyclical companies are performing better than non-cyclical ones.

More attractive valuations after correction

Due to increased worries about possible trade wars, higher interest rates, stagnating economic indicators and greater volatility, share prices have not moved significantly higher despite improved corporate earnings. This has led to lower valuations, making equities as an asset class appear more attractive now than a few months ago. Based on its valuations and future earnings forecasts, the EM sphere looks especially attractive. Using the same parameters, the health care sector stands out as relatively low-priced despite its structural growth and defensive characteristics. The IT sector is largely cyclical, but at the same time it is in a structural growth phase, which is appealing.

Summary

Due to positive quarterly reports and continued healthy economic conditions, we are moderately optimistic about equities. Reports from IT firms and companies with new internet-related business models were especially impressive. Cyclically sensitive companies continue to deliver strong earnings, while defensive companies that are being challenged by new market players are having a tough time.

EM equities should regain their popularity. Their valuations are in line with the long-term average, but company profitability is higher. We believe that IT and health care are attractively valued sectors that are in a structural growth phase. There are naturally specific risks in these sectors, but their valuations and profitability make them attractive.

For a Swedish investor, the krona is an important parameter that should be kept in mind when investing in foreign equity funds, which generally have full exchange rate exposure. All else being equal, krona appreciation will thus have an adverse effect.

Valuations by region and sectors

Region	P/E 2018	P/E 2019	Return on equity, %	
			2018	2019
United States	17.3	15.8	17.7	18.9
Europe	14.9	13.7	9.7	10.2
Japan	13.8	12.7	7.6	7.6
Emerging markets	12.3	11.1	12.1	12.5
Sector	**P/E 2018**	**P/E 2019**	**Return on equity, %**	
			2018	2019
IT	18.5	16.7	23.5	24.0
Non-durable goods	18.4	16.9	16.2	21.4
Durable goods	16.8	15.2	15.4	15.6
Industrials	16.6	15.1	12.5	12.6
Health care	16.1	14.8	23.4	23.8

Source: Bloomberg. On a regional basis, emerging market (EM) shares stand out as attractively valued, given their low P/E ratios and relatively high return on equity. On a sectoral basis, IT and health care seem the most attractively valued, given their P/E ratios, earnings growth and high return on equity.

Theme: Chinese equities

The continued liberalisation of China's stock market

This summer Chinese A-shares will be included for the first time in MSCI's world equity index, but in an initial stage only at a small fraction of their actual value. The direct effect is likely to be small, but it signals a further liberalisation of China's stock exchanges.

On June 1, 2018 Chinese A-shares will be added to the MSCI All Country World Index maintained by Morgan Stanley Capital International. According to MSCI, 99 of the world's largest asset managers use this index as a benchmark. A total of 243 large-cap Chinese companies are expected to be included, divided into two rounds. The second round will occur on September 3. This has been known for some time, and some portfolio managers have thus probably already bought shares of this type, but most have only a small weight in Chinese equities. Foreign investors will likely be enlarging their exposure to this type of Chinese shares in the future.

Since 2014 the liberalisation of China's financial markets has taken major steps in terms of foreign ownership and opportunities for foreigners to buy shares – among other major improvements. A maximum of 30 per cent of A-shares may now be held by foreign investors (up from 20 per cent in 2014), but this means that 70 per cent of these companies' total market capitalisation is excluded from the MSCI index.

About USD 20 billion in passive investments is expected to flow into Chinese A-shares this summer. Foreign ownership now totals a meagre 2.7 per cent of liquid shares. According to market forecasts, this may climb to a bit over 10 per cent, adding some USD 40-50 billion in yearly inflows. Global investors are massively underweight in Chinese equities, regardless of type. There is clear variation between sectors, with some overweighting in consumer goods and health care, but underweighting in financial services. For many investors, this summer's discussions about Chinese A-shares may serve as an alarm clock. China – the world's largest economy in purchasing power parity (PPP) terms – is rapidly shifting towards being a service-dominated society, offering very bright growth potential from a stock market perspective.

Most Chinese H-shares (listed in Hong Kong) – as well as Chinese equities listed in Japan, Singapore and of course also in the US – are already fully included in the MSCI world index. The weighting of Chinese shares may increase sharply, depending on how fast liberalisation occurs. China's stock market has grown dramatically since the early 1990s, from 0 to more than 3,500 companies. Nowadays the country has the world's second largest stock market if we include the two large exchanges in Shanghai and Shenzhen, where A-shares are listed. Overall market capitalisation is relatively diversified, with heavy weighting for sectors such as industrials, financial services and durable goods. State ownership is still widespread in such sectors as energy, financial services and industrials, but each year it diminishes and the efficiency of listed companies improves.

The first stage in June will include about 0.23 per cent of the market capitalisation of Chinese A-shares. This will be repeated in September (same companies, but more weight). As a result, about 0.45 per cent of total A-share market capitalisation will be included in the MSCI index, but later a higher proportion will be included (the full proportion that is investible by foreigners). This happened with South Korea in 1991-1998 and Taiwan in 1996-2004. After the two initial inclusions, Chinese A-shares are expected to account for only 0.1 per cent of the MSCI AC World Index and 0.78 per cent of the MSCI Emerging Markets Index. Only large-cap companies will be included. This addition to the global stock market is of course tiny but is an important consequence of the liberalisation that has occurred and is now gaining further momentum. At present (before the inclusion of A-shares), Chinese equities account for just over 3 per cent of the MSCI world index and 30 per cent of the EM index. Over the coming decade, Chinese A-shares have the potential to grow to more than 2 per cent of the world index and about 18 per cent of the EM index – on top of the Chinese shares already included, which are traded in Hong Kong and on other stock exchanges (mainly Nasdaq).

Conclusion

China accounts for about 13 per cent of the world economy in nominal GDP terms, but a full 19 per cent in PPP terms. Meanwhile 19 per cent of world population, or some 1.4 billion people, is in China. Half of the world's internet-based commerce occurs there. China is indeed well-populated, and the fact that it is both the world's largest economy in PPP terms and the clear leader in e-commerce suggests that in the future, its domestic stock market will probably become far more relevant on the global equity map. Adding Chinese A-shares to major benchmark indices should spur greater interest among investors worldwide, in spite of the initially small monetary impact. The Shanghai and London stock exchanges are also building a common trading platform to enable cross-buying of their listed shares, which is likely to boost investor interest in China even more in the future.

Nordic equities

Good potential for further gains

Nordic stock exchanges have generated a return of about 220 per cent since March 2009, measured by the VINX index. This is equivalent to an annual return of about 14 per cent. From a historical perspective, this is both a long and robust stock market upturn. Earnings have also increased sharply, but over the past year the return on Nordic equities has been significantly lower. Is the lengthy stock market upturn over for this long cycle? More lukewarm general economic growth can probably be expected going forward, which is why our fundamental outlook is more cautious than before – but still optimistic.

Can we expect a more lukewarm level of activity?

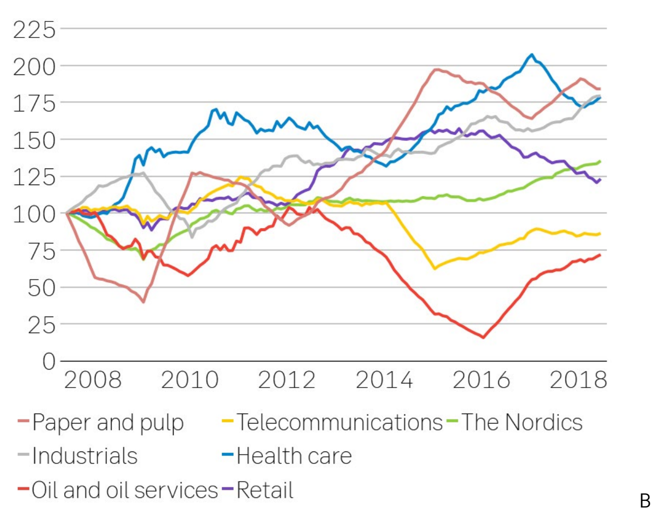
In the US, unemployment has reached a historically low 4 per cent. For the first time in 20 years the number of job openings is on a par with the total number of job seekers in the country. There is high employment is northern Europe, while there continues to be improvement potential in parts of southern Europe. In China, the transition to a service-based society has picked up speed, with the economy as a whole growing by about 6.5-7 per cent yearly, a far higher rate than in the West. The general economic trend is usually positive, but nearly every decade there is a brief economic slump after inflation has accelerated and employment has reached a high level. It is unusual to have a nine-year upward trend. We believe that it is too soon to have a clearly defensive portfolio, but some degree of caution can still be good. In Nordic equities, we prefer quality companies and companies with structural growth and relatively low cyclical exposure.

Very wide earnings gaps between Nordic sectors

The Nordic stock market has sizeable earnings spreads between sectors. One primary reason is that the four Nordic economies are relatively open to the global market, so companies in the region tend to be influenced by many different product segments. Meanwhile, competition in a number of industries has changed greatly. The most obvious example is network equipment production, where **Ericsson** and **Nokia** were once cutting-edge companies. Just over a decade ago, they had earnings of about 8 billion euros; this has now shrunk to about 2 billion euros. Earnings of the pharmaceutical company **AstraZeneca** have fallen by nearly half since 2010, while **Novo Nordisk** has multiplied its earnings many times over. Its share price has been driven by the company's own pharmaceutical research and development, not by the general economic trend. In highly cyclical sectors such as oil production and shipping, peak earnings have turned into losses several times since the turn of the millennium. For telecom operators, major structural changes have had a major impact on the sector's total earnings over time.

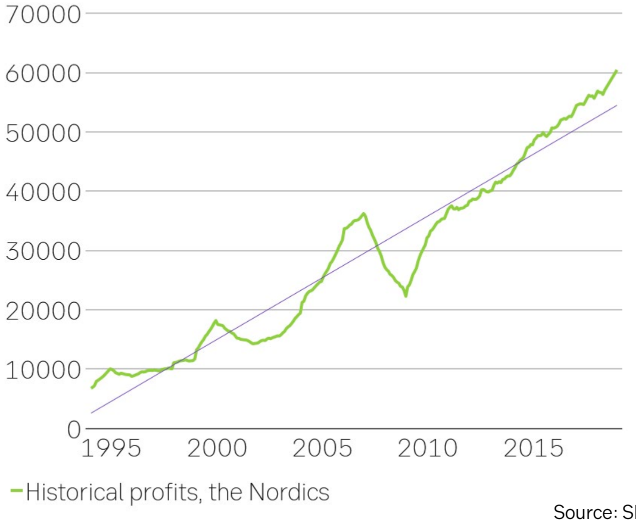
In 2007-2013, retail was one of the strongest-growing sectors in the Nordic region. Earnings then levelled out, falling by more than 20 per cent since 2015 despite a strong economy. One explanation is higher purchase costs due to a more expensive US dollar, but the main reason for the earnings decline is the great digital shift now under way. Competition is much keener because of the internationalisation of a number of retail segments. The Swedish-based clothing chain **Hennes & Mauritz** (H&M) accounts for about 75-80 per cent of the Nordic retail sector's earnings. The company undoubtedly faces a challenging future in modernisation terms, and it is not alone in dealing with such challenges. The earnings trend among industrials, as well as pulp and paper companies, has been robust since the peak of the last economic expansion, as the chart below clearly shows.

Large variations in earnings among sectors



The above chart illustrates the earnings trend for six different sectors, indexed at 100 = May 2007. There have been major differences in their earnings during this economic cycle, with large changes in individual sectors.

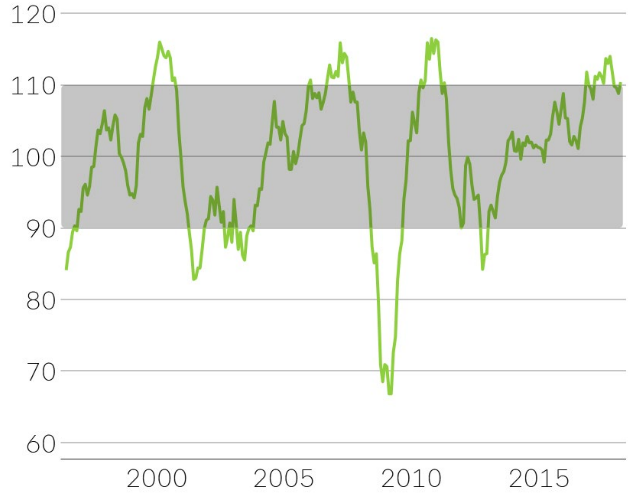
Nordic listed company earnings exceed historical trend



Source: SEB

The chart shows the historical earnings trend for Nordic listed companies (adjusted for major company-specific changes) since the 1990s. The steady positive trend in recent years points to a relatively mature business cycle.

Swedish tendency indicator at historical peaks



Source: NIER

Since the mid-1990s, the National Institute of Economic Research (NIER) has collected statistics on how companies and households view economic growth. Its economic tendency indicator summarises confidence indicators for manufacturing, services, construction, retail and households, based on company and household responses to the institute's surveys. Figures above 100 indicate a stronger economy than normal.

The reason for this discussion about sectoral earnings is that it is important to overcome cyclical fluctuations in the long term. Naturally, it is difficult to know which sectors or products will experience strong growth in the years ahead, although a demand analysis may be a good start.

Adjusted trend for Nordic stock market gains

Major company-specific changes have a strong impact on Nordic listed companies' aggregate earnings, which should be adjusted in order for us to determine where we are in the current economic cycle. The above chart shows historical earnings for Nordic listed companies, adjusted for major initial public offerings (IPOs) around the turn of the millennium, the declining competitiveness of telecommunications equipment companies, extreme fluctuations for companies in oil production and shipping, the massive change in earnings for pharmaceuticals and finally a number of major acquisitions. This earnings estimate is thus a relatively good way to get a sense of how strong the performance of Nordic listed companies is at present, as well as over time. Our conclusion is that the years leading up to the economic peaks of 2000 and 2007 were years with unusually sharp earnings increases. In the current economic cycle, the earnings trend has been robust but the direction has been steady. In recent years, growth has improved sharply in a number of industrial segments – one major reason why their earnings trend is significantly higher than the general trend.

Top earnings – but what does the tendency indicator say?

The National Institute of Economic Research (NIER) economic tendency indicator showed an index level of 110 in April, signalling a positive mood in Sweden. How does the current indicator level compare with historical levels? The figure exceeded 110 for most months in 2000 and in 2006-2007, and for 11 straight months during both economic peaks. These months coincided with US unemployment reaching lows close to 4 per cent, while unemployment in Sweden bottomed out one year after the US. At present, the indicator has noted ten months above 110 and three months marginally below that figure – a stretch of 13 months at close to this historically intriguing level.

Economic indicators such as low US unemployment, a high Swedish economic tendency indicator and historically high Nordic stock market gains may be parameters to keep in mind when the investment outlook is obscured by different factors. But every economic cycle is unique, which we have learnt from essentially every cycle over the past century, although a number of fundamental factors have provided very helpful hints. Our thesis is that we are currently in a relatively mature expansion period, but that relatively low yields and interest rates plus increased prosperity in major developing economies such as China and India (as well as other Asian countries) may temper the negative consequences when the economy cools down to a more lukewarm temperature (with implicitly higher unemployment). However, the historical earnings trend for different Nordic sectors has varied significantly, so it is even more important to choose the right sector and company.

Which sectors have the best growth potential?

We regard Nordic companies exposed to the current shift in major Asian developing economies towards service- and consumption-based societies as attractive in the long term. We are especially optimistic about product segments such as **food packaging, hygiene products, breweries, telecom operators** and **health care** or purely **digital services and solutions**.

When we look around us – at home, at the office, in the car, at the factory or outdoors – it is easy to see the revolutionary digitisation under way in every aspect of society. The digital economy still offers excellent growth potential, regardless of the state of the economy. Product segments such as e-commerce, automation, smart business systems and digital games are currently experiencing structural growth.

Network equipment is, of course, needed to ensure a reliable high-speed internet connection. The network equipment sector as a whole has faced a challenging business climate for years, after the big shift to fourth generation (4G) technology. The sector looks like it could benefit from the future shift to the next generation of technology (5G). It brings together many market players that are even more dependent on a reliable high-speed connection, for example in the automotive industry and manufacturing.

Which sectors have the weakest growth potential?

Most sectors are experiencing good demand at present and can report bright growth prospects. Then there are elements of the Nordic stock market where competition has increased significantly and which are probably only at the beginning of a long period of internationalisation. Retail includes about 10 per cent online consumption in Sweden, a middle-of-the-road country from a global perspective. This percentage will grow very rapidly. Traditional consumer-oriented companies that have an inadequate digital sales channel risk falling too far behind in this phase of modernisation to catch up to the rest of the pack. One sector that is likely to face increased competition going forward is the grocery industry, which is highly consolidated in Sweden and for which we have a negative outlook. However, modernisation is not just taking place in consumer-oriented companies but is creeping into nearly every segment of business and commerce.

If the general economic trend becomes more lukewarm in our part of the world, we may possibly see lower share prices for forest assets and related materials. We believe that parts of the Nordic forest-related sector now have relatively high valuations and should therefore be handled with a certain degree of caution, although the current situation looks favourable. We also believe that parts of the health care sector have historically high valuations, which cannot be attributed to solid research projects in relatively advanced stages of pharmaceutical studies.

Valuation – a residual?

The forward-looking price/earnings ratio for Nordic listed companies is over 17. This is high from a historical perspective. At the same time, we have a mature economic expansion. Continued relatively low yields and interest rates and ongoing revolutionary digitisation that increases efficiency and eliminates intermediaries in almost every aspect of our lives are also factors that can sustain historically high stock market valuations. So far this year, Nordic stock markets are up almost 4 per cent, a fairly sharp rise despite increased volatility in the world's financial markets. Meanwhile earnings have risen by 8-9 per cent at an annualised rate. As a result, the P/E ratio has been adjusted upward marginally. In the long run, valuation should be a residual, determined by the strength of the underlying economy.

Share valuations at relatively high levels historically

Source: SEB

The Nordic stock market's forward-looking price/earnings ratio (P/E) is based on about 250 companies that SEB monitors and has analyses for. The current ratio of about 17 is historically high in a situation where the economic cycle is relatively mature – but there are always attractive growth opportunities.

Fixed income investments

A divided central banking world

The most recent central bank announcements are divergent, with continued interest rate hikes by the US Federal Reserve while the European Central Bank (ECB) and Sweden's Riksbank have not yet shown any signs of being in a hurry to begin tightening their monetary policies. Going forward, spreads between key interest rates will widen even further, while moderate inflation pressure will limit the upturn in long-term yields.

Government bonds (excl emerging markets)

In its April interest rate announcement, Sweden's Riksbank postponed its projected first rate hike until late 2018. However, our inflation forecast indicates that the timing may be delayed even further and that the repo rate will not be raised until April 2019. Later that year it will be hiked again, so that by the end of 2019 it will be 0 per cent. Given our forecast that the Riksbank will wait until 2019 to hike its key rate and will continue to buy more bonds than are being issued, the spread against German 10-year bonds will remain narrow. However, in 2019 we believe Swedish yields will rise more than their German counterparts, since the Riksbank will probably raise its key rate a little sooner than the ECB. Our forecast is that Swedish 10-year bond yields will rise from 0.68 per cent today to 0.95 at the end of 2018 and 1.70 at the end of 2019.

Despite good economic growth, because of the sluggish rise in inflation the ECB's normalisation process will be drawn out and somewhat slower than we expected earlier. We have therefore also revised our forecast for German 10-year bond yields down to 0.80 per cent at the end of 2018 and 1.30 per cent at the end of 2019. Our assessment is that the next important signal for the final phase of bond-buying will come in July. We believe that the ECB's expansionary bond-buying programme will be extended one final time by three months, until the end of 2018, and that starting in October its monthly purchases will be halved to 15 billion euros. We expect the ECB to then also announce that its bond purchases will subsequently come to an end but that maturities and coupons will be reinvested. In other words, it will not withdraw liquidity, as the Federal Reserve (Fed) has started to do. Our forecast is that the ECB will take its first step to raise rates in June 2019, when it hikes the deposit rate it pays to banks by 0.15 percentage points to -0.25 per cent. The first hike in its refi rate, from 0 to 0.25 percentage points, is expected in September 2019.

Gradually higher inflation, an increased need for bond issues after an underfunded US tax reform and the Fed's continued shrinking of its balance sheet suggest that long-term US bond yields will rise. Inflation will stabilise at around the Fed's 2 per cent target and there will be a cautious deceleration in economic growth starting late in 2018. Based on this, we believe the Fed will hike rates three more times this year but that it will be satisfied with two rate increases in 2019, bringing the key rate to 3 per cent. We believe 10-year US Treasury yields will gradually rise to 3.15 per cent at the end of 2018 and 3.20 per cent at the end of 2019. However, there is a risk that they will climb even more.

Due to historically low yields and interest rates, many traditional fixed income instruments such as bond funds generate very low or no returns today. When market interest rates rise, bond prices in general fall as do prices for fixed income investments with long maturities in particular, since they carry a greater interest rate risk.

Emerging market (EM) debt

Prospects remain good for most emerging market (EM) economies. In 2018, EM debt in local currencies has also performed well relative to many other fixed income investments. Returns are a combination of high interest rates and yields in many emerging markets and a period of stronger EM currencies, which has further contributed to the upturn. EM debt also showed good resilience during the market turbulence in February-March. Both equities and fixed income instruments lost strength, while EM debt was one of the few asset classes that continued to perform well. However, recently EM currencies have slipped, leading to growing concern about the foreign exchange trend.

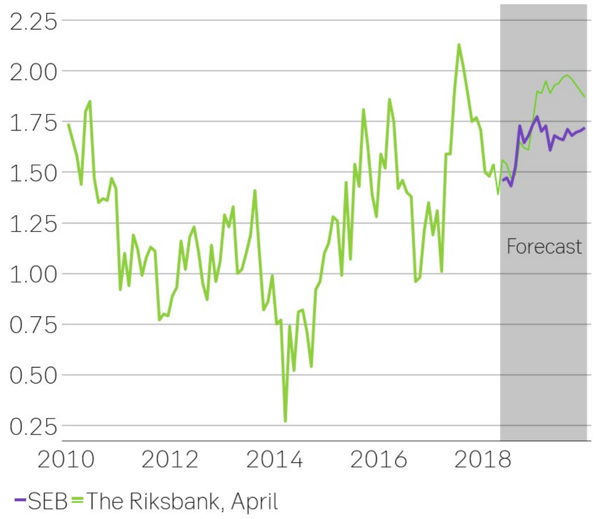
We see some continued potential for EM debt in local currencies but there is increased uncertainty, mostly about future exchange rates. We thus see less opportunity for additional returns through currency rate effects.

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

Low yields and narrow yield spreads against government bonds limit the return potential for both investment grade (IG) corporate bonds with higher credit ratings and high yield (HY) corporate bonds with lower credit ratings.

We see greater potential for HY corporate bonds than for IG ones, since HY bonds are not as sensitive to rising yields as IG bonds and the creditworthiness of HY companies remains good. However, in a historical perspective, there is also limited return potential for HY, given low absolute yields and narrow yield spreads against government bonds.

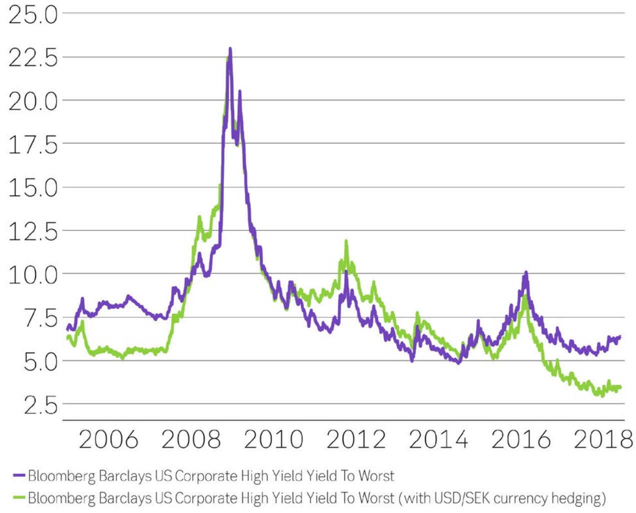
Swedish core inflation below Riksbank forecast



Source: Riksbank, Macrobond, SEB

Core inflation excluding energy is subdued. The downturn in service inflation continues, and food price increases are also slowing, in line with the broader European trend.

For SEK investors, currency-hedging costs will limit returns



Source: Bloomberg/Macrobond

”Yield to worst” shows the effective interest rate that investors are paid if all bonds are redeemed on the day they can be redeemed prior to maturity by the issuer. After adjusting for currency hedging costs, return potential is clearly limited. Given today’s spread between US and Swedish bond yields, the cost of hedging is around 2 per cent.

Alternative investments

A changed market – better or worse for hedge funds

If financial markets in 2017 were characterised by unusual calm in volatility terms, the trend early in 2018 has been quite different. After a robust January, volatility skyrocketed in conjunction with the market correction starting in early February. The markets have indeed stabilised in recent months, but at the same time it is clear that we have a different market situation today than last year – one that will most likely persist.

Hedge funds

There were two main factors that caused havoc for hedge funds in 2017. First and foremost is the fact that we then had – and to some extent still have – historically low yields and interest rates. The second was the absence of volatility in financial markets.

The conventional way to assess volatility is via the S&P 500 index of US stocks, which has an associated volatility index called the VIX. That index never went above 20 in 2017, which in itself indicates an unusually calm trading year. During the first quarter of 2018, the VIX surpassed 20 on 27 occasions.

If 2017 was an unusually calm year, we can state without hesitation that 2018 has provided a new market situation. If volatility was a necessary condition that was missing for hedge funds last year, one might assume that everything now is fine and dandy. The answer is both yes and no, since extreme and sudden changes in volatility are rarely based on fundamental investment decisions but instead on fear. For some hedge fund strategies, this is still manageable, but for others this kind of volatility can also be a disadvantage.

Equity long/short

Although some stock market movements during 2018 have been extreme, equity long/short strategies have managed to cope with these conditions fairly well. Because the political risks that we saw earlier in the year have diminished and volatility looks set to persist in relatively controlled forms, we see continued good potential for equity long/short to generate stock market returns. If our belief proves correct, we will see fundamental price discrepancies not just between companies but also between sectors. This kind of movement usually not only creates investment opportunities but can also provide conditions for stable risk-adjusted returns.

Credit

In recent years, the search for returns in the low-yield environment has narrowed yield spreads between corporate credits and government bonds to low levels. Meanwhile, fundamental factors such as the underlying economic trend, indebtedness and default rates remain stable. Nonetheless, buyer interest supported by expansionary central banks will probably wane, and there is a relatively high probability of lower demand for corporate credits. At the same time, yields and interest rates in many parts of the world will remain low for a while, although a number of central banks have signalled an upward direction in their key interest rates. As a result, we are cautiously optimistic about fund managers who try to find returns in what remains a narrow credit universe.

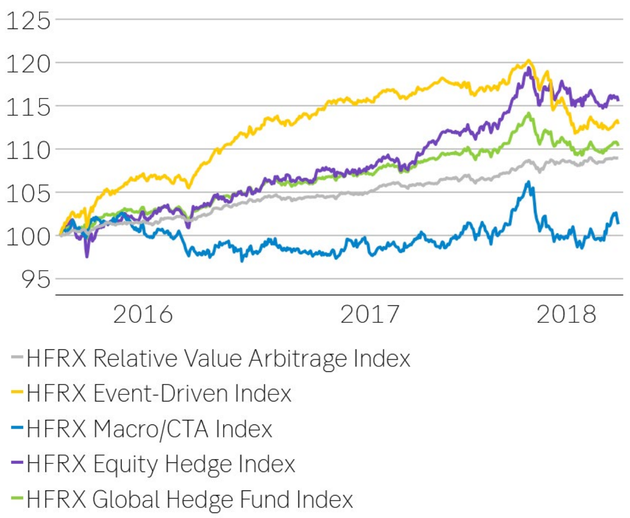
Event Driven

The recently implemented US tax reform has undeniably left its mark on the corporate transaction market. During the first quarter of the year, corporate transaction volume in the US was up 67 per cent compared to the same period in 2017. That is clearly good news for event-driven strategies; most fund managers have their greatest focus on this sub-strategy. However, given the above, this strategy could be hampered by surges in volatility. Higher volatility signals a risk that planned corporate transactions may be called off, usually leading to lower prices on the positions these managers have taken. Provided that volatility remains somewhat under control, we see continued good potential for this strategy.

CTA/Macro

After a record-strong performance for CTA strategies in January, life was anything but easy during the following three months. Stock market volatility together with sharp and sudden movements in currencies and fixed income instruments has depressed performance. This strategy depends on

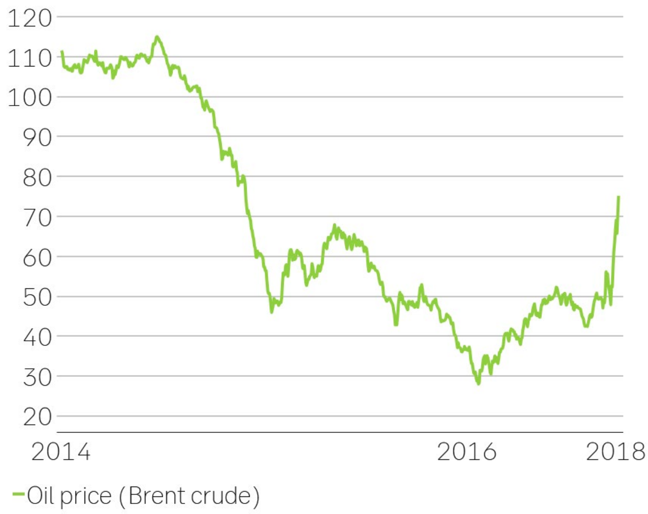
Performance of broad hedge fund indices over the past two years



Source: Bloomberg, Macrobond

For hedge funds, early 2018 was dominated by growing market volatility. After a robust start to the year for all strategies, the trend has been more divergent in subsequent months.

Oil prices since 2014



Source: Bloomberg/Macrobond

As shown in the chart, oil prices have risen sharply since OPEC+ agreed on production caps in early 2017. We expect this deal to hold for the rest of 2018 and 2019, although production limits will probably be eased.

a certain degree of sustained movements, which has not been the case during the spring. On the other hand, macro fund managers have seen somewhat improved conditions. Central banks have been relatively clear in their communication; combined with divergences between regions, this should provide good return potential.

Commodities

Higher oil prices, but OPEC+ in the driver's seat

Since our last issue of *Investment Outlook*, oil prices have climbed relatively sharply and stand at USD 75-80 per barrel (Brent crude). A number of factors are behind this upturn, and our assessment is that the level will remain at around USD 75-80 for the rest of the year. In 2019, we expect oil prices to be about USD 10 higher.

Our forecast is stable global economic growth in 2019 as well, with a sharp increase in oil demand as a result. US shale oil production will grow sharply, but so will demand. Global oil demand was unusually strong early this year. During the first quarter, demand grew by an estimated 2.5 per cent compared to the same period in 2017. Historically, year-on-year demand growth has been 1.3 per cent. Both in India and China, demand growth was 6 to 9 per cent during the first few months of the year. An unusually cold winter in the US also contributed to an increase in demand of more than 5 per cent during the quarter.

Since early 2017, oil prices have been bolstered by the OPEC+ deal to limit supply (which includes the Organisation of the Petroleum Exporting Countries, Russia, Mexico, Kazakhstan, Oman, Azerbaijan, Brunei, Malaysia, Sudan, South Sudan and Bahrain). The group controls about 56 per cent of global supply, so provided that they are agreed and there is a need, further limits could be introduced. In March this year, production restrictions were about 1.9 million barrels a day, with Saudi Arabia, Russia, Kuwait, the United Arab Emirates and Iraq accounting for 1.7 million. We expect the OPEC+ group to control the supply and demand situation for the rest of the year and in 2019, since the elimination of production caps would lead to increased global stockpiles and falling prices, a situation that the group wants to avoid. OPEC+ has been clear in its communication that current production caps will remain in place until stockpiles in the 34 mainly affluent countries of the Organisation for Economic Cooperation and Development (OECD) have fallen to their five-year average. This could potentially occur this month (May 2018). OPEC+ has meanwhile announced that it will continue to control the market and not allow stockpiles to grow.

Renewed US sanctions against Iran could potentially result in a reduction in Iranian oil exports this year by 0.5 million barrels a day. As for Venezuela, the country currently produces about 1.5 million barrels a day, compared to 2.4 million barrels in 2015. If supply falls faster and more than expected in Venezuela and Iran, we believe that OPEC+ will adjust supply to achieve oil market balance.

Potentially the greatest challenge for the oil market would be if we entered a global recession in 2019, which is not in our current forecasts. In such a scenario, we would have falling demand combined with a sharp rise in US shale oil production and an OPEC+ that has already cut production.

Unfortunately, there are plenty of other geopolitical risks with the potential to change the market balance. The political and economic situation in Venezuela is deteriorating and oil production there is falling far faster than we previously expected. Renewed US sanctions against Iran, Saudi Arabia's conflict with Yemen, concerns that US sanctions imposed on Russia will affect that country's oil exports and worries about Libya's growing political instability could all potentially affect the oil market balance.

Currencies

Uncertain outlook because of diffuse drivers

The drivers in the foreign exchange (FX) market vary between currencies. Traditional forces such as yield spreads and monetary policy expectations sometimes make themselves felt but often become irrelevant as worries about trade wars or imminent recession temporarily take the upper hand. We expect interest rate hikes to help strengthen the USD in the near term, but the EUR/USD rate will again head towards 1.25 in the slightly longer term. The Swedish krona has probably bottomed out after an unjustifiably large depreciation. However, it will appreciate relatively slowly since the Riksbank continues to pursue a highly expansionary monetary policy.

Cautious recovery expected for the krona

Despite continued high US interest rates, the dollar has had difficulty regaining its 2017 downturn against the euro. Not until April did a recovery become more apparent. The dollar is adversely affected by structural rebalancing flows as investors reduce their USD exposure, while a more stable euro zone economic and political situation is making the euro more attractive as a reserve currency. The latest statistics also show a clear diversification to other currencies such as the yen and the pound. The Chinese yuan seems to be attracting larger capital flows, too. But the interest rate differential between the USD and EUR is expected to persist, which makes currency hedging of USD revenues expensive. Given continued Federal Reserve rate hikes, the dollar will remain strong and the EUR/USD rate is expected to reach 1.16 during the summer. When other central banks, including the European Central Bank (ECB), later also begin normalisation, we believe these forces, along with USD-negative rebalancing, will reassert themselves. But the EUR/USD rate will trade within the range of 1.15-1.25 for a long time going forward.

Brexit is driving the pound

The Bank of England (BoE) does not want too weak a pound. Because the United Kingdom and the European Union have managed to agree on their divorce terms and on a nearly two-year transition period until December 31, 2020, there is less risk that the UK will leave the EU with no trade agreement. Although there are still thorny issues like the future trade agreement and border conditions in Ireland, progress so far has obviously benefited the undervalued pound. Despite continued risks, our optimistic main scenario for the outcome of negotiations implies that we expect a stronger pound, with the EUR/GBP rate reaching 0.86 at the end of 2018. However, in the near term, we believe that the pound may be weighed down by weak UK growth. Falling inflation will persuade the BoE not to deliver the key rate hike it has signalled.

Cautious recovery expected for the krona

Source: Bloomberg/Macrobond

The Swedish krona is trading at crisis levels, despite a robust economy. Although the Riksbank will not raise its key interest rate before year-end, the krona should be poised for an appreciation relative to the dollar and the euro purely for valuation reasons.

Both headwinds and tailwinds for EM currencies

The recent commodities rally is beneficial for many emerging market (EM) currencies. Meanwhile, President Donald Trump's anti-trade moves and threats along with rising US yields and interest rates have put a spanner in the works for most of these currencies. In a context of continued strong global economic growth and higher commodity prices, higher yields in EM economies should attract investors to these currencies as long as the US does not raise its interest rates too quickly and the USD does not appreciate significantly going forward.

Cautious krona recovery

The recent dramatic depreciation of the Swedish krona has been partly driven by seasonal SEK-negative flows related to spring corporate dividend payments. But the collapse is mainly due to the Riksbank's continued exceptionally loose monetary policy and yet another postponement of the central bank's first interest rate hike at its April meeting. Although the Riksbank's actions do not suggest any rapid SEK rebound, today's exchange rates are attractive and have historically only occurred during crisis periods. Despite risks in the economy, an isolated Swedish recession is unlikely. We thus expect a cautious recovery for the krona, although it may remain at weak levels for a long while. We believe that the EUR/SEK rate will reach 9.95 at the end of 2018 and then strengthen to 9.70 at the end of 2019.

NOK unjustifiably weak

The Norwegian krone is undervalued, and we see a number of underlying reasons for a movement towards more justifiable levels in terms of fundamentals. The Norwegian economy has recovered significantly since the oil price slide a few years ago, and despite low inflation the central bank is signalling a key rate hike later this year. This is widening already large yield spreads against the euro zone and Sweden. Because of higher oil prices, the Norwegian government did not need to use the returns on its Government Pension Fund Global early in 2018, so oil revenues may again provide a net flow to the fund that will strengthen the krone. We thus believe that the EUR/NOK rate will fall to 9.30 towards the end of 2018 and then to 9.00 in 2019.

Currency forecasts

Currency pair	Exchange rate					Change, %			
	Now	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2018	Q3 2018	Q4 2018	Q1 2019
EUR/USD	1.18	1.17	1.16	1.18	1.20	-1.2	-2.0	-0.3	1.4
EUR/SEK	10.29	10.20	10.15	9.95	9.90	-0.9	-1.3	-3.1	-3.8
USD/SEK	8.69	8.72	8.75	8.43	8.25	0.3	0.7	-3.0	-5.1
EUR/NOK	9.60	9.45	9.25	9.20	9.15	-1.6	-3.7	-4.2	-4.7
EUR/CHF	1.18	1.20	1.20	1.21	1.22	1.5	1.5	2.3	3.2
USD/JPY	110.2	110	111	110	108	-0.1	0.8	-0.1	-2.0
EUR/GBP	0.87	0.90	0.89	0.86	0.84	2.6	1.5	-2.0	-4.2
GBP/SEK	11.73	11.33	11.40	11.57	11.79	-3.4	-2.8	-1.4	0.5
USD/CNY	6.37	6.30	6.20	6.10	6.00	-1.1	-2.7	-4.2	-5.8

Currency forecasts were made by SEB Research & Strategy as of May 16, 2018. You are welcome to ask for a copy of our latest forecasts.

Theme – India

A colourful tiger economy

India is a poor country with massive bureaucracy and widespread corruption, but since 1991 the clear trend has been towards less economic regulation and more growth-oriented policies, especially under the current government headed by Prime Minister Narendra Modi. There are always critics who say that reform work in India is going too slowly or is not extensive enough; nonetheless, India is now the world's fastest growing economy of significant size. It is fascinating to see digitisation proceed at a furious pace, with enormous improvements in efficiency as a result, even in this poor country. India has a well-developed stock market; the 50 largest listed companies have a total market capitalisation of well over USD 1 trillion. International companies are making major investments in India, and the country's own savers have faith in the domestic stock market. We also consider the Indian stock market attractive, with its exposure to both high domestic growth and – through the country's internationally successful consultancy firms – the global digitisation trend.

Is India "the new China"?

At an investor presentation featuring the CEO of one of Sweden's largest industrial companies, the executive commented on an issue concerning India, saying "of course we are in India even though it is still a relatively small market, but we are growing and we are investing. We have to, since India is the next China". This description could be dismissed as being completely wrong, since there is a long list of crucial differences. At the same time, it may be quite accurate from the perspective of the company in question.

Following a deep economic crisis, India was at a crossroads in 1991; since then, it has implemented a number of extensive economic reforms. China began 13 years earlier, but both countries have drastically changed their economic policies and today are reaping the benefits. As a direct result of earlier reforms, the two countries also have by far the fastest growth among the world's major economies. However, India lags far behind, with a per capita GDP at purchasing power parities less than half that of China and one eighth that of the US (see table).

Going forward, India's development will also differ considerably from China's since India is a democracy and its social structure otherwise is also dramatically different. But from a company perspective, it is quite conceivable that India's growth potential over the next decade might be comparable only to that of China over the past 10-20 years. It is hardly surprising that direct investment in India by foreign companies has grown sharply over the past few decades and last year totalled more than USD 60 billion, a 75 per cent increase in five years. India is not "the new China", but we fully understand why many companies think in those terms and are not surprised that they consequently draw the conclusion that this is an attractive destination for their investments.

Key national data

	India	US	China
Population, million	1,330	328	1,400
Area, thousand km^2	3,287	9,832	9,563
GDP, USD billion	2,850	20,410	14,090
Per capita GDP (PPP), USD	7,780	62,150	18,070
Share of urban population	33	82	57

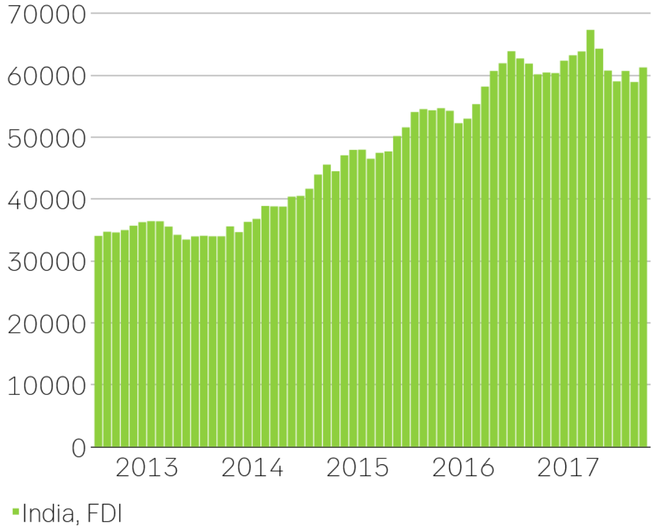
Source: World Bank, IMF. PPP = purchasing power parities.

India, key macroeconomic data

	2018 F	2019 F
GDP growth	7.4%	7.8%
Inflation, CPI	5.0%	5.0%
Public sector, % of GDP	28	28
Budget deficit (adj), % of GDP	6.5	6.5
Current account balance, % of GDP	-2.3	-2.1

Source: IMF. F = forecast.

International firms making big investments in India



Source: Bloomberg

The chart shows foreign direct investment (FDI) in India in millions of dollars on a moving 12-month basis. International companies have steadily and sharply increased their investments in India in recent decades. During the past five years alone, FDI has increased about 75 per cent, despite a clear deceleration after the currency reform in late 2016. Many companies and early indicators now signal a brighter economy in general. Will this also spur additional foreign direct investment in the country?

High growth, trending in right direction from low level

When a country improves from such a low level, its development will probably always be described as insufficient. But the trend is clear: this year, India climbed 22 places to 100th in the World Bank's annual "ease of doing business" survey of the corporate climate in different countries. According to International Monetary Fund (IMF) forecasts, GDP growth is expected to reach 7.4 per cent this year and then accelerate to 7.8 per cent in 2019.

The 2017 introduction of a single national goods and services tax (GST) is expected to bring about dramatic efficiency improvements for all of Indian society. Combined with the currency reform (read more on page 23) and a number of digitisation initiatives, GST can also be expected to spur a major shift in activity from the informal shadow economy to the formal economy. This change will also increase the transparency of company cash flows for potential creditors. Together with the introduction of long-awaited bankruptcy laws, this will also significantly enhance opportunities for external funding of small and medium-sized companies.

Meanwhile nearly the entire population has been given personal identification numbers linked to their biometric data. As a result of government initiatives, since 2014 more than 300 million new bank accounts have been opened for the poorest people in the country, and today most households have a bank account. This has enabled electronic payments of government benefits and subsidies directly to the intended recipients, creating enormous efficiency gains. The reported saving so far is about 20 per cent of the total value of payments, and the move has also probably reduced wastage and corruption along the way.

Yet the Modi government is criticised for not having delivered economic reforms at the pace previously promised. Many of the reforms are also of such a nature that they have initially had a negative impact on growth, although they should be very beneficial in the longer term.

GST – the most important reform so far?

Despite Trump and Brexit, the international trend for many decades has been to open up the world to free trade, for example by creating a "single market" in Europe. Most economists agree that free trade is beneficial to economic growth in both rich and poor countries. From that perspective, India long stood out as extremely deviant by not even practicing free trade within the country, instead having land customs stations between each state. National goods distribution was in practice unimaginable for companies in India, since trade flows between states required enormous time and administration. An average lorry in India was reported to spend only 40 per cent of its time driving; a large share of working hours used to disappear in queues at land customs stations. In 2017 a national goods and services tax (GST) was instead introduced, replacing some 30 old taxes and fees levied by governments at the state and federal levels.

The reform looks set to be an almost self-evident success in the long term. Electronic payment of taxes and refunds should bring efficiency gains, improve transparency and allow less room for wastage and corruption. In practice, the GST system will also make it costly and difficult for companies in the formal economy to trade with companies in the informal economy, which will be forced to become legitimate or stop selling to customers in the formal economy. The tax reform is supposed to be neutral in terms of the national tax burden but is still expected to bring in increased revenue overall as a result of greater compliance.

The reform has not been painless; it has been characterised by extensive teething problems. The tax rates have been changed repeatedly, companies have had difficulties handling the digital processes and government authorities have received complaints about late payments.

Because of simplified distribution channels, companies can concentrate their warehouse facilities in fewer locations around the country. That may have a negative impact on demand in a short-term perspective as many companies reduce their inventories at the same time. An even more short-term effect was also noted, for example, by the Finnish-based food packaging specialist Huhtamäki, the Nordic multinational with the largest exposure to the Indian market. When GST was introduced and tax rates were changed numerous times, many of Huhtamäki's most important customers – for example, Hindustan Unilever and Nestlé India – chose to run down their packaging inventories while awaiting clarity on new prices, since the authorities require prices to be printed on packaging. This is to ensure that the population in every state will enjoy the benefits of the tax reform. In its latest quarterly report, however, Huhtamäki noted that its growth in India is back at a healthy pace, 15 per cent organically, and it described the prospects for this year as very good.

Improvement in infrastructure

Eliminating domestic customs is obviously a major advantage in terms of transport and logistics costs, but the old customs system is not the only explanation for the sub-standard transport system in the country.

In India, more than half of all consumption in rural areas and one third in cities consists of food. Food and beverages have a 46 per cent weight in India's consumer price index, and this is often a critical factor behind inflation fluctuations. Changes in food prices generate major public discontent at times, both among consumers and farmers. For example, massive consumer protests against high onion prices broke out in 2010. Discontent smouldered again in 2015, but a crisis was averted through large-scale imports. Last year and also this year, farmers are the ones protesting, now against low onion prices.

According to Raghuram Rajan, former governor of the Reserve Bank of India, one important explanation for India's recurring food problems is sub-standard logistics, with a large share of the country's food production going to waste.

Infrastructure is a priority in India. Ground will soon be broken on the country's first high-speed rail project, a 510-kilometre line between Mumbai and Ahmedabad. It is symbolically important and is expected to cut travel time between the two cities from eight to two hours. More importantly from a macroeconomic perspective, the authorities are awarding motorway projects equivalent to 20 kilometres a day, and that pace will accelerate. The projects are funded by private investors, road tolls as well as public funds.

Electrification is also a priority, and in April this year Narendra Modi proclaimed that all villages in India have been electrified. In 2014, 18,452 villages or more than 3 per cent of the total number were still not connected to the grid. However, in order for a village to be considered electrified, 10 per cent of households and all important buildings such as schools and hospitals must be connected. There is still an enormous need for improvement.

Bankruptcies facilitate credit expansion

Under the current government, the country has put bankruptcy laws in place for the first time, allowing banks and other creditors to require financial restructuring or liquidation of failed companies. We see this as an essential condition for modernisation and future growth in the financial sector, but in the short term it has also helped to increase recognition of credit losses among banks.

India's public sector-controlled banks suffer from major credit losses and problem loans, which has made such banks this year's stock market loser – a continuation of the weak trend in recent years. In five years, the index for public sector banks generated a -5 per cent return while the stock market climbed 95 per cent. In clear contrast, shares in privately-held banks showed strong performance, with the two largest outclassing the stock market by about 140 per cent and 240 per cent, respectively.

The combination of new bankruptcy laws, a dramatic improvement in transparency for cash flows as a result of GST, the growing percentage of electronic payments and the use of bank accounts can be expected to significantly improve risk and cost control for the country's credit institutions. That should facilitate lending to large groups in society that so far have not had any significant access to credits – for example, small and medium-sized companies as well as households. At the same time, improved efficiency and risk control increases margin pressure. Given the normal connection between price and demand, this suggests an increased demand for credits. The stage is set for credit expansion in India, from what is today a very low level in international terms.

The public sector banks that have historically dominated India still have a combined market share of 55 per cent for lending, which in practice is focused on a small group of major companies. Total lending to small and medium-sized companies in India corresponds to only 10 per cent of GDP and 15 per cent of total lending in the country, compared to 57 per cent of GDP and 39 per cent of total lending in China. Total mortgages in India are equivalent to 10 per cent of GDP, compared to 26 per cent in China and 68 per cent in the United Kingdom.

Major credit losses and inefficiency suggest that public sector banks will continue to lose market share going forward and that private financial institutions will take the lion's share of market growth in this promised land of the tiger.

Biometric IDs, digital payments and currency reform

More than 1.2 billion Indians today have a personal identification number associated with their fingerprints or iris scans. Mobile phone penetration is well above 100 per cent in cities and 56 per cent in rural areas. Nearly every household is considered to have access to a bank account. Various electronic payment solutions backed by the government have also been launched. The ground has been laid for an unparalleled shift from a poor agricultural society to the modern digital age with regard to payments.

The surprising and costly currency reform of November 2016, in which old bank notes were declared invalid ("demonetised") as a means of payment overnight, appears to have failed from the perspective that was initially communicated. Since 99 per cent of all large bank notes (each worth the equivalent of USD 7.50 or 15) were exchanged for new money, it is hard to see that the destruction in the value of the black market – which was the stated reason for the reform – was proportionate to the economic costs in the form of lost GDP in the months immediately following the move. But one positive side effect, which the authorities also wanted to stimulate through these measures, was an acceleration in the use of electronic payment options, which has also been the case.

Digital payments have plenty of room for continued expansion. Only 8 per cent of private consumption in India today is by electronic payment, mostly using cards, compared to 92 per cent in South Korea thanks to government initiatives and 12 per cent in Germany.

Walmart and Amazon see the future in India

India also still lags far behind in e-commerce. Only 2 per cent of retail sales take place on the internet and 10 per cent of the population shops online, but high mobile phone penetration, good infrastructure for electronic payments and sub-standard physical infrastructure for shops – though supplemented by extensive street trade – will provide favourable conditions for e-commerce in the future.

We are clearly not alone in our conclusion. US retail giants Walmart and Amazon have been fighting each other for some time to acquire a controlling interest in India's leading e-commerce company, Flipkart. Walmart now looks set to win the bidding war and will pay USD 16 billion for 77 per cent ownership of the company.

A young and growing population

Most wealthy countries face significant challenges in managing an ageing population with a shrinking percentage of working age people, who must support more and more pensioners. India is in a completely different situation. It has a young population with a median age of 28, compared to 37 in China, 43 in the EU and 47 in Japan. In fact, of the whole world's expected growth in the labour force (working age population) over the next ten years, 27 per cent is expected to come from India. The challenge instead will be to create enough new jobs and train this future labour force to a sufficient extent.

There are still major shortcomings in India in terms of education as well, although the trend is in the right direction. Today virtually all children of primary age attend school, as do 75 per cent of those of secondary school age. In the 15-24 age category, illiteracy rates have decreased significantly in recent decades.

Urbanisation has just begun

Only one third of the country's population lives in cities, compared to 57 per cent in China and 82 per cent in the US, and the difference between city and countryside is enormous. In India, city dwellers have an income averaging six times higher than people living in rural areas. They spend only 33 per cent of their household budget on food compared to 58 per cent for households in rural areas, even though they spend a much larger share of their food budget on packaged brands. Some 74 per cent of city dwellers use the internet, compared to 15 per cent in rural areas, but high mobile penetration combined with a rapidly rising percentage of smart phones suggests that this gap could narrow going forward.

At the same time as the urban population is increasing from a low level in international terms, the caste system provides unique incentives for continued urbanisation in India. In cities there are government ministers, business executives and university vice-chancellors who would never get anything but the worst jobs if they still lived in villages.

Political stability, voters with new economic aspirations

India is an extremely heterogeneous federation of widely differing states, ethnicities, religions and language groups. During its first few decades as an independent country there were serious threats to its existence, and discord between different groups often verged on civil war. Today there is a stabilising combination of extensive regional independence and a shared "Indian" identity. This fundamental stability makes it easier for politicians and voters to focus on other matters.

Young people in cities today have completely different aspirations than previous generations in rural areas, who were trapped by the caste society's customs and traditions. In the past five to ten years, political scientists have seen a clear pattern in which the educated urban middle class has begun to demand far higher standards of law and order than voters have done historically. Another parallel development that ensures continued pressure on politicians to deliver growth-oriented reforms is competition between states and their governments.

General election in 2019

Next year there will be a general election in India, and it remains to be seen whether the current government will win re-election. A number of important reforms implemented in the past few years have unfortunately resembled bitter medicine – unpleasant in the short term, but beneficial in the long term.

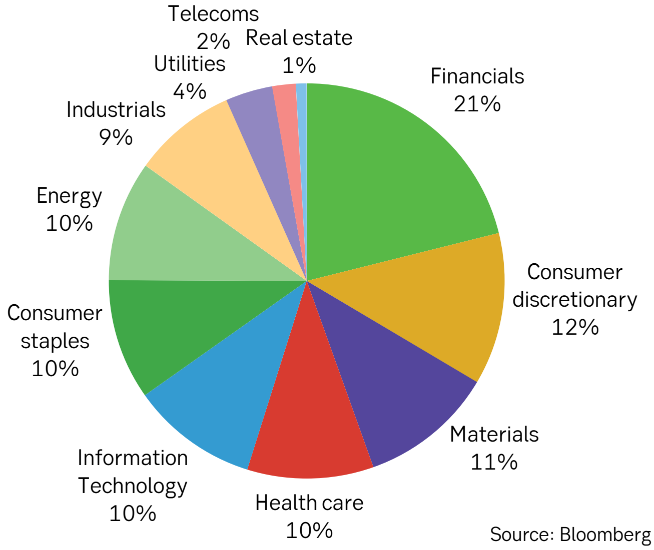
Surveys (based on federal and state elections) indicate that voters, two thirds of whom still live in rural areas, are sensitive to short-term effects on their own well-being. Important indicators to follow over the next year from this perspective include sales of tractors and two-wheel vehicles. One factor beyond the authorities' control but which always has a major impact on the economy is the weather, since more than half of voters are farmers. The current government's efforts to crack down on the black market, which includes a large share of low-paid workers, are not an entirely positive factor when people go to the polls. People who have lost their jobs because of GST and digitisation probably do not see these developments as desirable.

From a stock market perspective, the general election next year constitutes a risk. The current government's majority in the lower house of parliament has made it far easier for Modi to implement difficult reforms such as GST. It is hard to see how the situation could be further improved, and all changes entail an element of uncertainty.

Short-term macroeconomic challenges

One challenge for the Indian economy that cannot be overlooked is the country's heavy dependence on oil. India's oil import bill is among the highest in the world, so the economy has been a big loser from sharply higher oil prices this past year. The situation is especially difficult since the economy is already characterised by both trade deficits and government budget shortfalls.

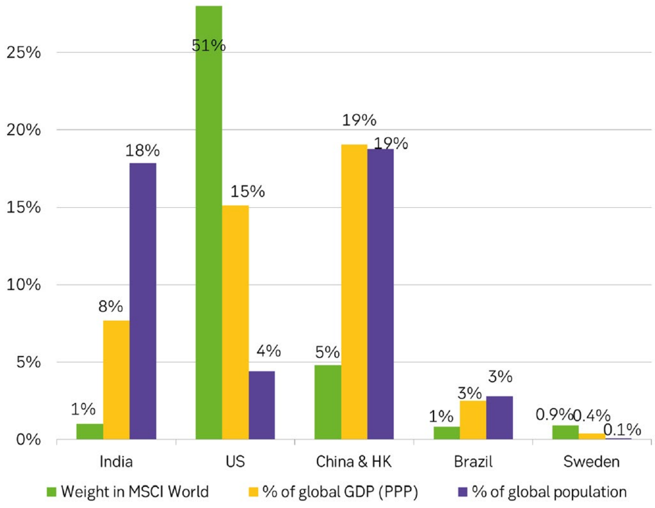
Western stock market structure, limited commodities exposure



Source: Bloomberg

The chart shows market capitalisation by sector for the BSE 500, the index of India's 500 largest listed companies. The share of commodities companies – 10 per cent for energy (including a large share of refinery- and petrochemical-related operations) and just under 3 per cent for mining and metals (included in Materials) – is relatively low for a country with India's level of development, while the share of IT and health care companies is suggestive of more developed economies.

Large population, medium-sized economy, small percentage of global equities



Source: Bloomberg, IMF

The chart shows India's share of the world's total population and GDP as well as the total weight of Indian equities in the MSCI All Country World Index, along with corresponding figures for the US, Sweden, Brazil and China including Hong Kong as of May 2018. However, it is worth noting that China's stock market weight will soon increase when the MSCI All Country World Index begins to include China's A-shares; read more on page 11.

Western stock market structure, optimistic small savers

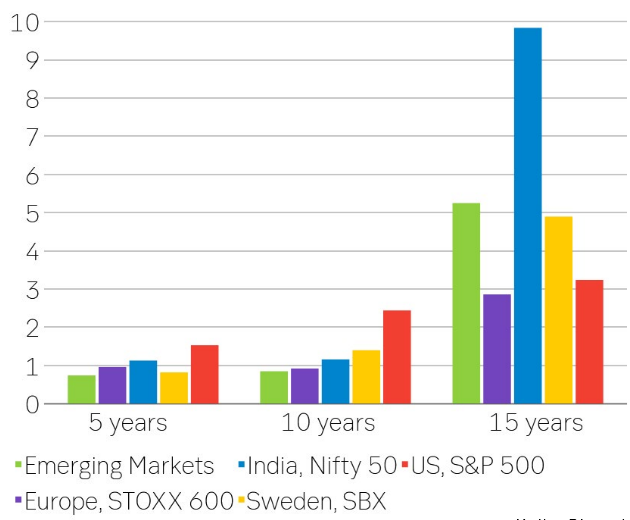
The Indian stock market is large and well diversified in terms of sectors. Total market capitalisation is equivalent to well over USD 2 trillion, with the 50 largest companies constituting roughly half of this. The share of commodity companies – 10 per cent for energy and nearly 3 per cent for mining and metals – is relatively low for a country with India's level of development, while the share of IT and health care companies is suggestive of more developed economies.

However, for global investors India is still a tiny economy. In what is probably the most widely used global stock market index, the MSCI All Country World Index, Indian equities have only a 1 per cent weight, similar to Sweden and Brazil, despite an economy many times larger and 18 per cent of global population.

Indian equities have historically generated good returns, driven by both earnings growth and multiple expansion. Valuations do not stand out compared to markets like Sweden and the US, although multiples have expanded over the past five years. We do not find these valuations frightening, but they are not attractive either. One interesting feature of the Indian stock market is its internationally successful IT consulting firms, for example Tata Consulting, Infosys, Wipro and HCL Technologies. All except Tata are valued today at lower multiples than the index since investors nowadays prefer companies with exposure to domestic private consumption, particularly consumer staples companies. The big consumer staples companies are valued at a P/E ratio of 50-70, which means that a fair share of future earnings growth has already been factored in.

Foreign investors have been fairly tight-fisted with Indian equities, and the most important flows into the country's stock market in recent years have instead come from domestic savers via equity funds. Is the increased interest in equities among the Indian general public due to a change in savings behaviour – the traditional form of savings, gold, clearly seems to have declined in relative attractiveness – or to their having a more long-term perspective about the economic reforms of recent years?

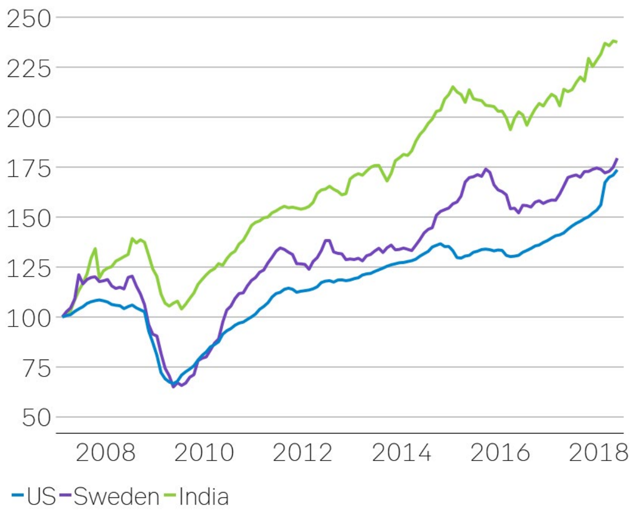
Indian equities have historically been a good investment



Källa: Bloomberg

The chart shows total return in Swedish kronor to May 2018, calculated on an equity investment over five, ten and fifteen years in India (Nifty 50 index), Sweden (SBX index), the US (S&P 500 index), and emerging markets in general (MSCI Emerging Markets index).

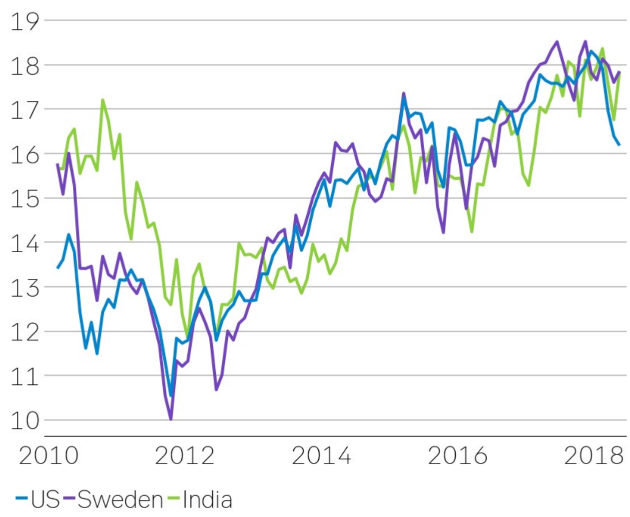
Subdued earnings growth since 2015: is it time now for an acceleration?



Source: Bloomberg

The chart shows indexed earnings forecasts for India (Nifty 50 index), the US (S&P 500 index) and Sweden (SBX index) in local currencies since 2007. Indian companies made it through the financial crisis relatively well and have maintained some of their lead since then, but in recent years that lead has narrowed. Calculated in dollars, the earnings growth of American companies has now surpassed that of Indian companies in the period shown. Earnings as a percentage of GDP are now at their lowest level in 14 years, but Indian stock market analysts believe that earnings will surge in 2019 and 2020.

Somewhat higher valuations than historically, but not extreme compared to other markets



Source: Bloomberg

The chart shows the P/E ratio for the Indian stock market (Nifty 50 index) compared to the Stockholm (SBX index) and the US (S&P 500 Index) stock markets. Valuations are relatively high from a short-term historical perspective but not extreme in an international comparison. Indian equities tend to be valued higher than those in many other emerging markets.

Higher earnings growth waiting around the corner

Earnings growth for Indian listed companies outclassed that of their Swedish and American counterparts in 2007-2014 but then lost momentum in relative terms. Translated into the same currency, US companies had better earnings growth over the past eleven years, while Indian companies did marginally better than Swedish ones during the same period. However, it is interesting that while earnings as a percentage of GDP are at historically high levels in the US, they are relatively depressed in India. With a real annual Indian GDP growth rate of around 7 per cent and inflation of 5 per cent, nominal GDP growth is 12 per cent. On average, analysts expect aggregate earnings growth for Indian listed companies of about 20 per cent in 2019 and another 12 per cent in 2020. Some of the world's most highly respected investment banks foresee far higher earnings growth than this in 2020.

A number of leading indicators and stock exchange releases point to clearly improved economic activity in India right now, as the initial negative effects of GST and the currency reform fade.

One negative factor in this context is that, with already high expectations for the year ahead, there is limited room for upside surprises. In the short term, surprises tend to be an important stock market driver.

Summary and conclusion

For many Nordic listed companies, India should stand out as an unusually promising and attractive place to do business. India is the fastest growing major economy in the world, and the country is developing from a low level on many fronts in the right direction. There is still enormous improvement potential, but reforms already implemented can be expected to help the economy keep growing for a long while ahead.

The Indian stock market is thus attractive in the long term, even though valuations already factor in relatively good earnings growth over the next year. Obvious risk factors are the country's negative exposure to higher oil prices and the approaching general election in 2019. There is tremendous potential in the long term, but the challenges are significant and the risk is relatively high.

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