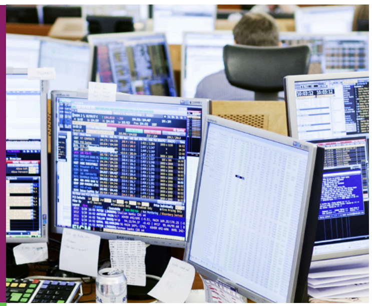
Monthly Newsletter

Market focus shifts from Trump to Fed rate hike

SAVINGS AND INVESTMENTS



MARCH 2017

Market overview

Despite the politics dominating investor's discussion, markets have made a calm start to the year, the volatility has been notably low. February was a bit shorter than other months, but it was just full of economic releases and market movers, equity indexes across the globe hit record highs. Meanwhile economic data and leading indicators generally continued to surprise on the upside. Much awaited Donald Trump's speech in United States Congress touched on many proposed reforms but lacked details, causing market focus to shift back to discussions about when the next interest rate hike by The US Federal Reserve (the Fed) may take place. Expectations were notably higher and now it is almost sure about interest rate hike this month. Our view towards risky assets remains to be more positive than neutral.

Stock markets*

USA
(S&P 500 index, USD):
+3,7% in February
+5,6% YTD
+73,1% *in 5 years*

Europe
(MSCI EURO, EUR):
+2,6% in February
+1,2% YTD
+41,5% *in 5 years*

Eastern Europe
(MSCI EM Eastern Europe, USD):
-3,6% in February
-1,6% YTD
-36,3% *in 5 years*

Asia
(MSCI EM Asia, USD):
+3,6% in February
+9,7% YTD
+3,9% in 5 years

Latin America
(MSCI EM Latin America, USD):
+3,3% in February
+11,1% YTD
-38,9% *in 5 years*

Major events and expectations

US. In his first speech to US Congress D. Trump reiterated most of his election promises including a "historic tax reform with massive tax cuts", USD 1 trillion in infrastructure investments, the construction of a wall with Mexico and the replacement of Obamacare, but **did not offer any details** about how they will be done and how they will be financed. However, in the media the **speech was received largely positively** after Trump showed a more conciliatory side and called for domestic collaboration with the Democrats.

Policymakers of the Fed have been resoundingly clear that **the Fed will raise its key interest rate by 0.25% on March 15**. Thanks to strong economic data and a shift in Fed rhetoric, now this fact seems to be quite obvious, so it would take something big to stop the central bank from acting at its next policy meeting. **We believe that this rate hike will be followed by two more in 2017 and three during 2018**.

While political developments are the focus of market attention on both sides of the Atlantic, **economic data continue to surprise on the upside**. It is the third consecutive month of favourable purchasing managers' indices (PMIs) in various major economies including euro zone and US. The Surprise Index (Bloomberg), which measures the difference between positive and negative data surprises, is at its highest in the US since 2012. This further supports the thesis that **political turmoil will not be an obstacle to an economic upswing**.

Among **US growth signals** is a 44-year low for initial jobless claims. The Institute for Supply Management (ISM) manufacturing index is at its highest since 2014 and the ISM's non-manufacturing PMI is at its highest since October 2015. Meanwhile the consumer confidence is at its highest level in more than 10 years. The latest **report season was also strong,** with three fourths of S&P 500 companies showing better earnings than expected. This indicates that the **pattern of recent years – with a weak start for US growth – will not recur in 2017**.

In Europe, the reporting also has not concluded, it is estimated that Q4 2016 EPS growth is around 9% (year-on-year) for the largest European companies (Euro Stoxx 600 index). **A weaker euro and higher commodity prices provide a positive outlook for earnings growth in Europe in the next twelve months**.

In the political realm, French and Dutch candidates continued campaigning towards their respective elections. Most recent polling data suggests that Geert Wilders the leader of populist Party for Freedom, who stated to leave the euro and EU if he gets into power, will be unlikely to gain full control of the Dutch parliament. Projected outcomes for the second round of French elections have either Emmanuel Macron or Marine Le Pen.

Political risks are increasing pressure on the **European Central Bank (ECB) to remain passive in upcoming meetings**.

Emerging markets are being challenged right now by protectionist signals from the United States and a strong US dollar, but looking a bit further ahead this may provide an attractive buying opportunity. Although oil prices have stabilised, **we remain cautious about commodities**.

* More information regarding indexes' performance can be found at the end of the document

SEB

Impact on investments of different risk categories

Product group	Impact during the last month and expectations looking forward
Low risk (conservative)	Government bond yields have been rising since the 2016 Q3 triggered by more favourable economic growth outlook, less accommodative monetary policy by Fed, ECB tapering and inflation expectations that picked up, driven by higher oil and commodity prices. The trend of rising yields remains and we remain having a negative view of government bonds.
Medium risk (balanced)	In February our balanced risk portfolios provided sound positive returns mainly because of value increase of risky assets. In January we increased risk level in portfolios and in March we increased it even more by decreasing fixed income investments and increasing equity exposures. Among fixed income investments we see better long-term value in high-yield corporate bonds. Rising commodity prices have stabilised the previously acute situation in portions of the credit market, now resulting in a better balance between actual yields and the expected percentage of defaults.
High risk (aggressive)	After increasing our risk tolerance in January an even more in March, we are retaining overweighting for risk assets. We see continued signals of stronger economic growth, increasing the probability that there will be a much anticipated upturn in corporate earnings. The odds of this have also improved, since the commodity sector is benefiting from better pricing and the financial sector from a reversal in low interest rates. Meanwhile the stock market greatly needs actual delivery of earnings in order to justify valuations.

Monthly theme

Global economy resilient to new political challenges

The interplay between economics and politics was undoubtedly a dominant feature of analyses during 2016. As we know, it was difficult to foresee both election results and their economic consequences. It was certainly not strange that economists were unable to predict the Brexit referendum outcome or Donald Trump's victory, when public opinion polling organisations and betting firms failed to do so, but lessons might be learned from the economic assessment impacts they made. Economists probably tend to exaggerate the importance of more general political phenomena. While in the midst of elections that appear historically important, it is tempting to present alarmist projections about election outcomes that seem improbable and/or unpleasant. But once the initial shock effect has faded, more ordinary economic data such as corporate reports and macroeconomic figures take the upper hand.

Psychological effects often exaggerated

One important observation is that it is difficult to find any historical correlation between heightened security policy tensions and economic activity. Households and businesses do not seem to be especially sensitive in their consumption or capital spending behaviour. This is perhaps because uncertainty is offset by investments in a defence build-up, for example. Only when the conditions that directly determine profitability and investments are affected, for example via rising oil prices or poorly functioning financial markets, will the effects become clear.

Markets also seem to have a general tendency to assume that the economic policy makers can actually behave rationally in crisis situations, until this has been disproved. Both during the US sub-prime mortgage crisis of 2007-2008 and the euro zone's existential crisis a few years later, for a rather long time the market maintained its faith that a response would come. Not until after a lengthy period of inept actions by decision makers did these crises become genuinely acute, with large secondary effects as a consequence. This market "patience" is presumably based on a long-time pattern of recurring bailout measures by governments and central banks, which usually benefit risk taking at the expense of caution or speculation that policy responses will not materialise.

It is reasonable to assume that this may also underpin the rather cautious reactions to the risks associated with the Trump administration's agenda. Although one cannot complain about the administration's power of initiative, there is a fairly high probability that in important areas it will not go from words to actions. There may be various reasons for this, such as the inertia built into the separation of powers between the White House, Congress and the court system, or expectations that Trump's newly appointed cabinet secretaries and advisors will eventually take their cues from more established US positions.

Indicators point to a sharper upturn

From a forecasting standpoint, there are naturally many genuine uncertainties to deal with in the present situation. However, we adjusted our growth outlook somewhat higher. Business and household optimism has greatly strengthened during the past six months, both in the US and globally. At first it was hard to distinguish to what extent this was due to enthusiasm for Trump's new fiscal policies. But over time it has become increasingly clear that underlying forces are actually strong. In particular, this is reflected in the strong corporate reports of recent weeks, which could not reasonably have had time to be influenced by political events. We are probably now in a phase of the economic cycle where capacity utilisation has reached such high levels that it will trigger capital spending activity on a broader front. The oil price recovery has also benefited the world economy, easing pressure on producer countries while remaining low enough to have a stimulus effect on countries that are net importers of oil.

In fact, the significant recent upturn in sentiment indicators points to a substantially stronger growth wave than implied by our main scenario and to an even greater extent by the prevailing consensus forecast. The risk picture thus includes unusually great potential for surprises during 2017-2018, but stronger growth may be generated partly by factors that are neither desirable nor sustainable in the long term. Such driving forces may include unfunded US stimulus measures, a de-prioritisation of global and national environmental targets that benefits the energy sector in the short term, a defence build-up due to increased security policy tensions or a phase-out of financial market regulations implemented in response to the financial crisis. These forces might then be amplified by underlying pent-up consumption and capital spending needs in many countries, where such factors as growing wealth and high household savings ratios represent a potential.

Why such optimism about economic policies by Donald Trump

Although there are reasons to de-emphasise the political aspects of economic optimism, it is still clear that economic policies by Donald Trump, despite its bizarre aspects, has awakened interest and hopes in financial markets and among economists. In various areas, economic policies since the financial crisis have reached an impasse – thereby creating fertile ground for challenges. For example, the downside aspects of exceptional monetary stimulus measures – in the form of widening economic gaps, inflated balance sheets and decreased reform pressure – were a popular theme last autumn. This generated speculation about a large imminent paradigm shift similar to the breakthrough of active fiscal policy in the 1930s, the collapse of the Bretton Woods system in the early 1970s or the breakthrough of the neoconservative era around 1980 which included financial deregulation and inflation targeting.

Another way of reasoning is that in a number of areas the Trump administration is now, albeit in often provocative fashion, pushing the US in a direction that was nevertheless unavoidable, considering the country's relatively weakened economic position. One clear example is Trump's questioning of the mission and financing of NATO. Corporatist tendencies that assign a greater role to cooperation, for better and worse, between business and government may also become a new trend. To summarise, economic policies by Donald Trump is certainly not the solution to the prevailing economic policy problems, but in the best case it may ask challenging questions and move the discussion forward by revealing weakness and dead-ends in once predominant approaches. More worrisome, of course, would be if the administration's often provocative behaviour should drive up the level of conflict in public discourse in ways that instead blocks fresh economic policy thinking.

Too early to write off political downsides

Given such dramatic events as British withdrawal from the European Union and a Trump administration in the White House, it is still difficult to dismiss the risks of economic reversals. The domestic political conflict between the Trump administration and other key players in American society may deepen in more or less dangerous ways. The US may also change its policies so dramatically that it leads to trade wars or crucial disruptions in the functioning of international organisations like the United Nations, International Monetary Fund or World Bank. Therefore, our positive and negative scenarios that diverge greatly from our main scenario is bigger than usual.

In the near term, the focus will be on the risks that elections in Europe will increase uncertainty about the future of the EU. Dramatically unexpected election outcomes in Germany and France would have greater secondary political effects than recent votes in major English speaking countries have had; the EU can hardly exist without a strong commitment by its founding and core countries. But despite the successes of the EU-critical German political party AfD in public opinion surveys, it is difficult not to believe that some kind of stable government led by the CDU (Angela Merkel) or SPD (Martin Schulz) can be formed after the September parliamentary election. The outcome of this spring's French presidential election is more uncertain, which is reflected in the widening of the spread between German and French government bond yields.

In France, according to opinion polls, François Fillon of the Republicans and Marine Le Pen of the National Front led in first-round polling. However, it appears unlikely that right-wing populist Marine Le Pen will win the crucial second round, considering that in earlier elections the traditional right and left have joined forced to stop the National Front's candidates. But Republican candidate François Fillon's falling public support – due to questions about his alleged financial improprieties – have boosted uncertainty. The first round of the 2017 French presidential election will be held on 23 April 2017. Should no candidate win a majority, a run-off election between the top two candidates will be held on 7 May 2017.

Regardless of the 2017 election outcomes, it is difficult to foresee any positive shift that could rejuvenate the EU project. The euro zone is thus also vulnerable and dependent on European Central Bank stimulus. In such an environment, financial markets will continue to focus on politics and it is tempting to let this influence economic forecasts. But the lessons of 2016 indicate that it takes more than mere political uncertainty to bring the economy and financial markets to their knees.

Source: SEB

Glossary

Terms used	Explanation
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Fiscal policy	Fiscal policy relates to government spending and tax collection. Fiscal policy refers to the use of the government budget to influence economic activity. For example, when economic growth is slowing down, the government can step in and increase its spending to stimulate demand and economic growth. Or it can lower taxes to increase disposable income for people and businesses.
Investment grade bonds, high yield bonds	Investment grade bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively low risk of default. High yield bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively higher risk of default than investment grade bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Two main credit rating agencies Standard & Poor's (S&P) and Moody's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. S&P designations of 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as high yield or "junk bonds".
Monetary policy	Monetary policy is the process by which the monetary authority (usually the central bank) of a country controls the supply of money (the size and rate of growth of the money supply), for the purpose of promoting economic growth and stability. For example, if the money supply grows too fast, the rate of inflation will increase and the economy will "overheat". If the growth of the money supply is slowed too much, then economic growth may also slow. The main tools to control money supply include open market operations (buying or selling assets), changing interest rates and changing reserve requirements for commercial banks.
Purchasing managers' indexes (PMIs)	An indicator of the economic health of the manufacturing sector. The PMI indexes are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.
The Institute of Supply Management (ISM) ISM manufacturing, non-manufacturing indexes	An index based on surveys of manufacturing/non-manufacturing firms by the Institute of Supply Management in US. An index with a score over 50 indicates that the industry is expanding, and a score below 50 shows a contraction. By monitoring ISM manufacturing and non-manufacturing indexes, investors are able to better understand national economic conditions. When this index is increasing, investors can assume that the stock markets should increase because of higher corporate profits. The opposite can be thought of the bond markets, which may decrease as indexes increases because of sensitivity to potential inflation.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Stock market indexes performance information covering the immediately preceding 5 years till 28 February, 2017

Region	Index	Currency	Performance						
			2012	2013	2014	2015	2016	12 months	2017 YTD
USA	S&P 500	USD	13,4%	29,6%	11,4%	-0,7%	9,5%	22,3%	5,6%
Europe	MSCI EURO	EUR	15,6%	19,6%	2,3%	6,1%	1,7%	13,7%	1,2%
Eastern Europe	MSCI EM Eastern Europe	USD	13,2%	-2,9%	-40,0%	-8,1%	33,0%	31,6%	-1,6%
Asia	MSCI EM Asia	USD	18,1%	-0,2%	2,5%	-11,8%	3,8%	24,5%	9,7%
Latin America	MSCI EM Latin America	USD	5,4%	-15,7%	-14,8%	-32,9%	27,9%	44,1%	11,1%