MANDATUM LIFE

Market Outlook

5 January 2018

A new investment year begins – strong global economic growth supports the markets

Globally, economic growth is currently strong, with GDP growing in practically all of the OECD countries and even accelerating in many. The new investment year is supported by exceptionally broad-based and strong economic growth around the world. This has of course already been factored into the money markets and 2017 was the strongest upward year since 2009, with the MSCI World All Country index rising +19.8%. Interest rates remained relatively low due to moderate inflation and the resulting stimulating central bank monetary policy. We are coming into the new year in a neutral position in our allocation products in terms of equity weight (read more in our Allocation insight).

On the fixed income markets, the year ended with a slight rise in interest rates. However, the interest rate level remained exceptionally low in Europe in the long term, compared to current economic growth. The non-existent inflation is the factor due to which central banks in Europe are only now, very slowly, dismantling their massive stimulus measures. This holds a possible element of surprise for this year: even a moderate rise in inflation due to the impact of rising wages, raw material prices and other factors might shift the current factoring in of the ECB's key interest rate (first key interest rate hike scheduled for mid-2019) closer to the present. Short and long-term rates would rise as a result.

The corporate bond markets featured the largest ever scramble onto the issue markets, with companies buying up financing from the bond and bank loan markets. Credit risk premiums are at this cycle's bottommost figures and the low level of the underlying interest rate is pushing companies' interest expenses downwards. For investors, this means selectivity when choosing bonds. In our view, many corporate bonds were ineligible for investment at the end of last year.

Globally, equities reached the best figures since 2009, with the MSCI World All Country index rising +19.8% last year. In the US, the total return on the S&P 500 index was +21.8% (in dollars), but due to the weakening of the currency, only +6.9% (in euros) without hedging. Meanwhile in Europe, the Stoxx 600 index's total return was +10.6%, which meant that, finally, Europe performed better than the US (in euros).

Last year, the stock volatility was the second lowest in US history measured during the calendar year, as equities rose without any significant turbulence. Earnings growth expectations have supported this: currently, +11.5% earnings growth is slated for the S&P 500 index for 2018, accompanied by a significant decline in the corporate tax rate, and +9% earnings growth for the European Stoxx 600 index. Also the earnings forecasts of emerging market (EM) stock markets have been raised, which means that global economic growth and the positive earnings forecast development will provide the equity markets with support as we enter the new investment year.

Juhani Lehtonen,
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Investment Solutions

Market returns 29 December 2017

Fixed Income	Return 1 mth	Return 2017	Return 1 yr
JPM Money Mkt	0,0 %	-0,3 %	-0,3 %
JPM EMU Govt	-0,8 %	0,4 %	0,4 %
Barcleys Infl.Linked	-0,6 %	1,4 %	1,4 %
JPM Credit Index	-0,3 %	1,1 %	1,1 %
JPM High Yield	0,2 %	6,2 %	6,2 %
JPM GBI EM Divers. (LC)	1,3 %	1,2 %	1,2 %
JPM EMBI+ (HC)	0,6 %	8,3 %	8,3 %

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	0,1 %	11,5 %	11,5 %
Euro Stoxx 50	-1,7 %	9,2 %	9,2 %
Stoxx 600	0,7 %	10,6 %	10,6 %
S&P 500	1,1 %	21,8 %	21,8 %
Dow Jones	1,9 %	28,1 %	28,1 %
Nasdaq	0,5 %	29,6 %	29,6 %
Nikkei (Japan)	0,3 %	21,3 %	21,3 %
Hang Seng (China)	2,6 %	41,3 %	41,3 %
India	2,7 %	29,6 %	29,6 %
Russia (RTS)	2,6 %	5,0 %	5,0 %
Brazil	6,2 %	26,9 %	26,9 %
MSCI Europe	0,8 %	10,2 %	10,2 %
MSCI World All Country	1,3 %	19,8 %	19,8 %
MSCI Emerging Markets	2,6 %	30,6 %	30,6 %
MSCI Latin America	6,1 %	22,1 %	22,1 %
MSCI Eastern Europe	1,9 %	6,9 %	6,9 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	4,4 %	5,8 %	5,8 %
Oil (spot)	5,2 %	6,2 %	6,2 %
Gold (spot)	2,6 %	12,0 %	12,0 %
HFRX Global HF	0,5 %	3,5 %	3,5 %

Foreign exchange	29.12.2017	30.11.2017
EURUSD	1,20	1,19
EURJPY	135,28	133,96
USDJPY	112,69	112,54
EURGBP	0,89	0,88
EURSEK	9,83	9,97
EURNOK	9,84	9,90
Interest rates		
Fed	1,50	1,25
ECB	0,00	0,00
BoJ	-0,10	-0,10
BoE	0,50	0,50
Euribor 3m	-0,33	-0,33
Euribor 12m	-0,19	-0,19
Germany10y	0,43	0,37
iTraxx Europe 5y (IG)	44,78	48,41
iTraxx Crossover 5y (HY)	232,38	229,92

Source: Bloomberg. Past performance is no guarantee of future results.

Fixed income

Past situation

Fed tightens, ECB continues to stimulate

The fixed income markets lacked major movements at the end of the year. Interest rates turned slightly upward in Europe but the interest rate level remains astonishingly low in relation to economic activity (Germany's 10-year at +0.45%). This is largely the result of low inflation, which is why the ECB is maintaining its massive monetary stimulus policy. The ECB provided the markets with an update on its outlook in mid-December. It is now expecting euro zone growth to reach +2.4% for 2017 and +2.3% for 2018. The ECB expects core inflation, less energy and food, to wind up at +1.1% in 2018. It is not much and this is exactly where the fixed income markets' hot topic lies.

Thanks to the rapid improvement in the economic situation, the unemployment rate has fallen to 9% in the euro zone and to 5.5% in Germany, which has previously been an indication of bottlenecks in the labour markets in certain sectors. The wage negotiations on Germany's labour markets will provide a guideline for raising wages, which means, in our view, that keeping abreast of wage inflation is important when assessing the central bank's monetary policy setup.

In the US, long-term interest rates rose more evidently already at the end of 2016, from which level they have already stepped slightly downwards, but the 10-year government bond remains at the 2.45% level, which is 2 percentage points higher than Germany. Due to the Fed's interest rate hikes, the interest rate on the 2-year government bond is already 1.92% and has thus risen more, in relative terms, than long-term interest rates, which means that the yield curve (difference between short and long interest rates) has levelled out in the US. The transatlantic interest rate differential at the short end is the price that euro investors have to annually pay for dollar hedging. The government bond index returned +0.4% and the corporate bond index +1.1% in the euro zone last year.

Current situation

Companies rush to the loan markets

The number of new corporate bond issues beat the previous record at the end of 2017. In Europe, more than EUR 65 billion in high yield corporate bonds were issued and on the Nordic markets the amount was more than EUR 13 billion in local currencies. Despite the enthusiastic issue rate, corporate bonds still represent just slightly over 4% of companies' financial liabilities, while in the US, the corresponding figure is around 11%. There is thus plenty of room remaining for market growth. However, credit risk premiums are, in practice, at their lowest this cycle and have remained firmly entrenched there. At the same time, the loosening of loan terms, familiar from earlier cycles, has now resulted in the same situation.

Thanks to high investor demand, companies no longer need to lock their loan terms too tightly, for instance in terms of covenants. The looseness of covenants has been commonplace in the US for some time, but the same can now be said about Europe and the Nordics as well. We have very selectively participated in new issues of corporate bonds and equally carefully in the bank loan markets.

In many cases, we have estimated that the prevailing return level on a bond or loan is not in line with the risk. Thus, the volume of cash has accumulated slightly in our ML Fixed Income Portfolio, for instance, providing a good starting point for the new year's scenarios. On the whole, patience is the word of the day in the current fixed income market environment, where tight credit risk premiums fail to provide a sufficient buffer against any future company-specific challenges. The Nordics remain an interesting environment for fixed income investors; it is possible to invest in the 5.5% return level of our ML Nordic High Yield investment basket, for example, with an amount of interest rate risk corresponding practically to that of the money markets.

The future

Keeping an eye on interest rate risk

Bonds and money market instruments equipped globally with negative interest rates come to more than USD 10,000 billion, which means that the possible rise in interest rates is not a trivial matter for asset prices. According to our calculations, a brisk 2% surge in interest rates along different maturities, in euros, would lead to a similar crash on the global markets, as the one the financial crisis inflicted just on the equity markets.

The implications of an interest rate surge will be extensive, as it is well known that the negative and low interest rate environment has changed investors' and speculators' behaviour also in other and completely new instruments. However, as long as inflation is nowhere near the central banks' targets, a rapid tightening of monetary policy is not on the cards. A lot will depend on inflation as the economic cycle develops, and any unused capacity will be taken into production in various sectors. The future pricing of inflation on the markets appears low: the five-year period starting in five years is at around 1.73%, or, still clearly below the ECB's 2% goal. At the same time, economies are growing well, even in southern Europe.

Globally speaking, economic growth is currently at its strongest and most broad-based this cycle and we are headed for 2018 in a Goldilocks scenario: inflation is low and growth is solid. As for companies, the latest confidence indices in Germany were good in December: 63.3 (unchanged) and 60.6 in the euro zone (also unchanged from November). The UK's PMI fell to 56.3 (previously 57.9), with the impacts of Brexit slowly beginning to affect economic development.

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Equities

Past situation

Strongest surge since 2009

The past investment year was the strongest equity market growth year since the recovery from the financial crisis in 2009. The MSCI World AC index rose +19.8% and in the US S&P 500 +21.8% (in euros just +6.9%). Volatility was, correspondingly, the second lowest since 1964, which caused volatility-adjusted (Sharpe ratio) equities to return extremely well in the US last year. In addition, on the S&P 500 index, each individual month of 2017 was in the black, which has never before occurred in the long history of the index. In this sense, we can already speak of an unusual stock price surge in the US. Sector-wise, information technology companies (sector +39%) yielded the best returns in the US, followed by materials (+24%) and the consumer sector (+23%). The weakest were telecommunication services and energy.

In Europe, the Stoxx 600 index returned +10.6% and the best performing sectors were basic industry and technology. Last year's winners were, however, emerging market equities. The brisk upgrade of earnings forecasts, fuelled by economic growth, pushed China (Hang Seng +41%) and many Asian emerging market stock markets to rise sharply. As a whole, the MSCI EM index rose +30.6% last year. Of the emerging market stock markets, Russia was relatively weak with the RTS rising just +5% last year despite the sharp surge in the oil price. The Helsinki stock market (OMXH Cap index), rising +11.5%, beat out the other European broad indices last year.

Current situation

Earnings forecasts continue to be raised

The raising of companies' earnings forecasts supports the surge in stock prices at the beginning of the new year. Right now, the markets forecast +11.5% earnings growth for US S&P 500 index companies, which could be achieved with a +5.6% growth rate in sales. The markets are currently raising their forecasts, immediately following the major tax reform in the US, which will reduce the corporate tax rate. In Europe, the Stoxx 600 earnings growth forecast for this year is +9% and the growth forecast for net sales +3.9%. Forecasts were raised further at the end of 2017, aided by the positive economic development.

The best upward momentum in earnings forecasts in late 2017 was seen in Japan (2018 earnings growth expectation currently +8.7%), led by the weakened yen. The earnings forecasts of the emerging markets index have been raised similarly and expectations are the strongest in this market in 2018 – earnings are expected to rise +13.2%. Globally speaking, earnings growth forecasts are at a good level and what is key for the continuation of the short-term rise in the main equity markets is that they are currently being raised. The starting up of earnings reporting for the past year will prove interesting especially when it comes to US companies: what do companies think of the tax reform and what will the reactions be on the markets. In Europe, economic growth has spread and global European companies are also benefiting from the slashing of the US corporate tax rate. In Germany, the DAX index's earnings expectation for this year is +10% and in Italy, the MIB index expects as much as +15%, driven by the banks. The overly-rapid strengthening of the euro early on in the year may dampen the mood in European export companies in the short term, but otherwise, fundamentals for European companies are looking good.

The future

US tax reform approved

The United States' tax reform package, substantial even historically speaking, was approved by Congress and its implications are being feverishly factored in on the equity markets. The corporate tax rate will decline from 35% to 21%, which is its lowest level in decades. It is very possible that the fall in corporate tax may mainly improve, in the long run, companies' earnings accrual, so this alone will not have any wider-reaching impacts on the US national economy, or subsequently on the macro markets. Changes to households' loan interest rate deductions may affect the real estate markets, but these impacts are likely to be minor.

President Trump's policy to improve the operating conditions of domestic companies notched its first win as a result of the tax reform. The shutting down of the government was avoided at the end of the year in the US and now, by the 19th of January, the debt ceiling must be raised. The USD 1,500 billion budget deficit linked to the huge tax reform needs to be filled and there is not much time to get the budget in shape.

The Fed has not changed its policy despite the challenging fiscal situation; it will raise the key interest rate two or three times this year. At this rate, short-term interest rates will rise to more than 2% and the yield curve (difference between short and long-term interest rates) will level out more, indicating challenges for the banking sector and further afield, by raising the likelihood of a downturn. In contrast, the real economy is experiencing strong growth with almost full employment. Not until the real interest rate (interest rate level adjusted with inflation) begins to be clearly over 1% will the situation change more clearly in this economic cycle. The new investment year is starting with the support of strong global growth. The valuation levels of equities rose slightly towards the end of the year, but the equity markets' upward trend is strong globally and we have remained in neutral position in terms of equity weight in our allocation products (read more in our Allocation insight).

Alternative investments

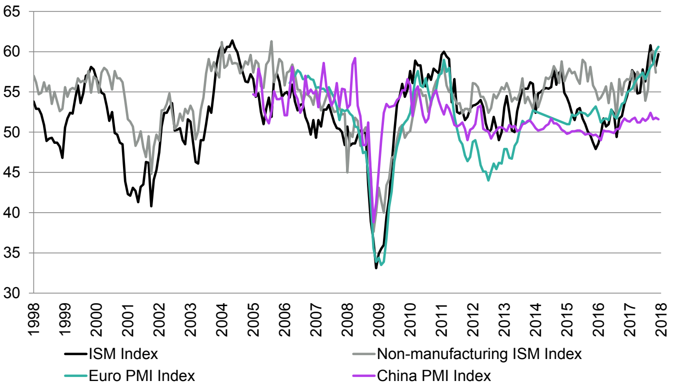
With regards to alternative investments, nothing new appears to be at hand. The low level of risk-free interest rates particularly in the euro zone is still driving investments to asset classes with no daily redemption opportunities. Thus, investors are looking for higher yields resulting partly from this weaker liquidity and the related liquidity premiums. This is well-suited to many investors' portfolios.

The investment capacity in European private debt funds has still not grown significantly in light of statistics. New investment opportunities are steadily flowing onto the private debt markets with, for instance, the tightening of banks' regulation framework opening up new opportunities for investors. The yield levels on new private debt bonds have not fluctuated very much globally since 2013. In our view, the market situation is still relatively positive for the Mandatum Life Private Debt investment baskets, from the perspective of long-term investors, particularly compared with traditional asset classes.

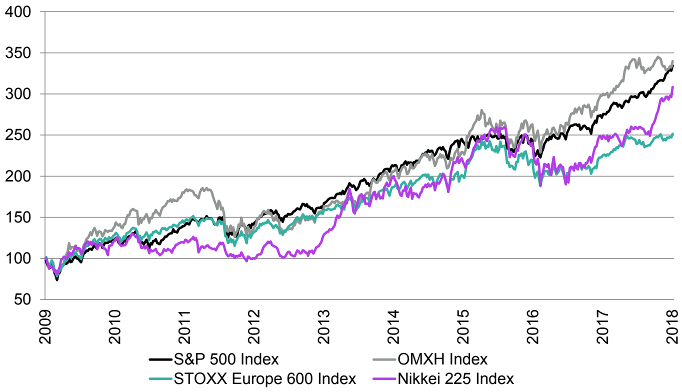
The private equity markets' valuation levels are nearing their all-time highest levels. The performance of private equity funds last started up at these valuation levels between 2006 and 2007 remained low once the financial crisis hit the markets in 2008. At the moment, the volume of investment capacity in private equity funds is at an all-time record level.

On the European real estate markets, and especially for core properties (best offices in city centres), returns for investors have fallen to their all-time lowest level due to high demand and the low interest rate level. At the same time, the valuation levels of underperforming real estate (e.g. half-empty office premises etc.) have not risen correspondingly. Due to the core market situation, our Mandatum Life International Real Estate investment basket is focusing on investments in so-called value add and loan-form properties where we still see good return potential.

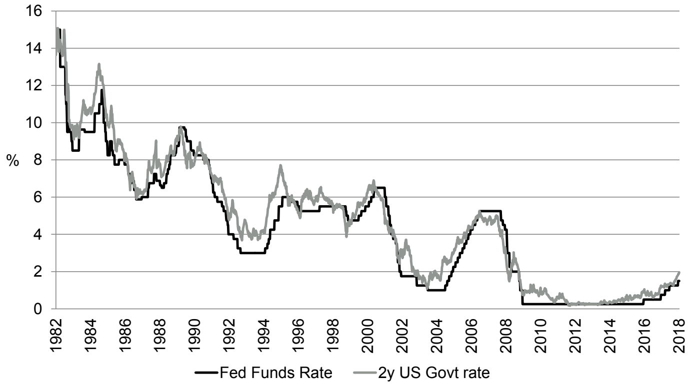
PMI development



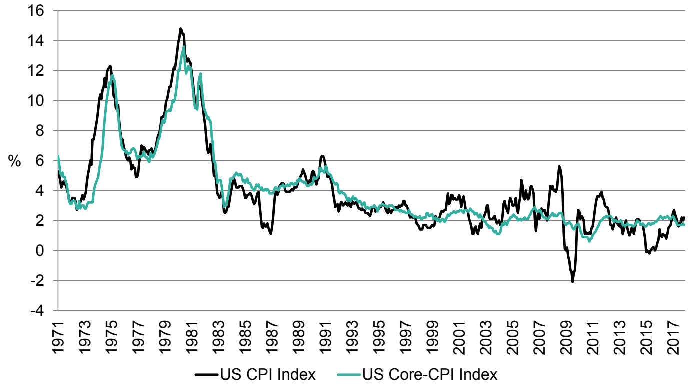
Equity indexes (2.1.2009 = 100)



Fed funds rate and 2y government bond yield



US consumer price index and underlying inflation



Source: Bloomberg. Past performance is no guarantee of future results.

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