MANDATUM LIFE

Market Outlook

7 February 2018

New investment year starts briskly – downward interest rate trend ends in euro zone

Global economic growth forecasts are being raised as we speak. The currently synchronised global GDP growth is expected to rise to +3.7%, which is the best rate in years. The economic growth environment is strong and interest rates have begun to rise also in Europe, where a rise in inflation linked to growth is being factored in. Companies' earnings performance appears to be strong and the US tax reform is reinforcing it even more. January's stock price surge (MSCI World +4.1%) was the strongest start to the year in living memory. Our allocation products are still positioned in neutral in terms of equity weight (read more in our Allocation insight).

Interest rates took off immediately at the start of the year. The interest rate of Germany's 10-year Bund rose from +0.44% at the start of the year to +0.68%, which is still a very low level. In January, in the euro zone, the government bond index resulted in a loss of –0.4% for investors and the fixed interest rate risk corporate bond index in a loss of –0.7%. This clearly shows the short-term impact of interest rate risk when credit risk premiums themselves are so low that they cannot compensate for the negative market impacts arising from growing interest rates in corporate bonds with higher credit ratings. The euro zone's GDP grew +0.6% in Q4, summing up the growth for 2017 at a good +2.4% level. Inflation has not yet begun to rise significantly, but due to a low underlying effect, this summer may show clear, headline-worthy inflation figures of more than 2%. The ECB will thus have to justify later this year why the key interest rate is still so clearly below zero, when, at the same time, the downward trend in long-term rates has ended in the euro zone.

The year began at a historically strong level on the equity markets. The United States' S&P 500 index rose by +5,7% in dollars in January and the European Stoxx 600 index +1.6%. The earnings season thus took off with a good market momentum and the first glimpses of earnings have been strong. When approximately half of S&P 500 companies have reported their earnings for last year, US earnings growth will have risen to as high as 15%, which is clearly stronger than expected (+11.5%).

This year's earnings growth forecasts were quickly revised upwards in the US, to +15.7%. During January, driven by the US, earnings growth forecasts were also raised globally, by more than 2 percentage points, with the earnings season looking successful elsewhere as well. Still, at the start of February, the equity markets showed some decline, following an upward trend in January. This is natural considering the strength of the upward trend.

Juhani Lehtonen,
Head of Fixed Income & Market Strategy
Investment Solutions

Market returns 31 January 2018

Fixed Income	Return 1 mth	Return 2017	Return 1 yr
JPM Money Mkt	0,0 %	0,0 %	-0,3 %
JPM EMU Govt	-0,4 %	-0,4 %	2,2 %
Barcleys Infl.Linked	-0,5 %	-0,5 %	2,6 %
JPM Credit Index	-0,7 %	-0,7 %	1,2 %
JPM High Yield	0,2 %	0,2 %	5,5 %
JPM GBI EM Divers. (LC)	0,7 %	0,7 %	2,1 %
JPM EMBI+ (HC)	-0,5 %	-0,5 %	6,2 %

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	2,6 %	2,6 %	16,1 %
Euro Stoxx 50	3,1 %	3,1 %	14,5 %
Stoxx 600	1,7 %	1,7 %	12,8 %
S&P 500	5,7 %	5,7 %	26,4 %
Dow Jones	5,9 %	5,9 %	34,8 %
Nasdaq	7,4 %	7,4 %	33,4 %
Nikkei (Japan)	1,5 %	1,5 %	23,6 %
Hang Seng (China)	9,9 %	9,9 %	46,3 %
India	5,6 %	5,6 %	31,7 %
Russia (RTS)	11,1 %	11,1 %	15,4 %
Brazil	11,1 %	11,1 %	31,3 %
MSCI Europe	1,6 %	1,6 %	12,4 %
MSCI World All Country	4,1 %	4,1 %	22,8 %
MSCI Emerging Markets	6,8 %	6,8 %	34,1 %
MSCI Latin America	8,3 %	8,3 %	25,6 %
MSCI Eastern Europe	8,2 %	8,2 %	15,5 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	3,4 %	3,4 %	11,0 %
Oil (spot)	7,1 %	7,1 %	16,7 %
Gold (spot)	2,2 %	2,2 %	9,2 %
HFRX Global HF	2,2 %	2,2 %	5,4 %

Foreign exchange	31.1.2018	29.12.2017
EURUSD	1,24	1,20
EURJPY	135,54	135,28
USDJPY	109,19	112,69
EURGBP	0,87	0,89
EURSEK	9,78	9,83
EURNOK	9,57	9,84
Interest rates		
Fed	1,50	1,50
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	0,70	0,43
iTraxx Europe 5y (IG)	44,19	44,78
iTraxx Crossover 5y (HY)	237,48	232,38

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

Fixed income

Past situation

Upward interest rate trend ends

Interest rates turned around at the start of the year, rising clearly in Europe and the US. The interest rate of Germany's 10-year Bund rose to 0.68% when the ECB's hawkish message sank in on the markets. According to the ECB, inflation is still low, but the economy has recovered well. According to the ECB, the winding down of stimulus measures must meet three criteria: inflation must be slightly below 2%, central bankers must be relatively confident in their forecasts and economic development must be able to withstand the ending of monetary policy stimulus. This is still far into the future, but it is not long before the ECB's bond purchases finish at the end of September this year. The key interest rate is unlikely to be raised this year.

The euro zone's GDP grew +0.6% in Q4 and summed up the growth for 2017 at a good +2.4% level. In Spain, growth came to +3.1% and +1.9% in France, which is the best rate since the start of the euro crisis in 2011. Also in Italy, the industrial PMI rose to 59.0, the highest figure since 2011. The year thus began on the fixed income markets with an airing out of ideas concerning the ECB's monetary policy. The rise in interest rates is, in fact, just a prelude if the central bank's message becomes even more hawkish. After all, the "return" on Germany's 5-year government bond, even after the rise in interest rates, was just +0.1%, which does not include any kind of premium for a rise in interest rates. It is clear that the downward trend in interest rates has now ended in the euro zone but it is still uncertain whether this means that a new upward trend is on the horizon.

Current situation

Redemptions from US high yield funds

The corporate bond markets' situation has shown some signs of calming down. Global and US high yield funds and especially ETFs (exchange traded funds) have shown relatively large redemptions, but assets flowed onto the Norwegian high yield fund markets at the end of the year. For example, in the US, slightly more than 15% of iShares' HYG-ETF (High Yield Corporate Bond ETF) has been redeemed over the past year, which is undoubtedly a fairly large figure in such a short time period.

More than EUR 300 million in assets was redeemed from European HY funds over the first three weeks of January. On the issue front, activity in January was slightly more mellow than at the end of last year, with, for instance, the European IG markets (BBB- or higher credit rating) offering an 18% lower bond selection year-on-year, and the dollar markets also had a 25% slower start to the year. The surge in interest rates has caused investors and issuers to slightly reassess the market situation.

Even after this year's slight widening, credit risk premiums are still, in practice, at the bottom of the cycle in the long term, so as US interest rates continue to rise, the US HY-ETF can be expected to lose more assets. The situation is calmer on the bank loan markets and a few new issues have been made in the early part of the year on the European markets too, even at slightly better levels than the end-of-year return levels. In Norway, the HY markets' situation continues to be ideal as it is practically founded on a floating interest rate structure. Thus, rising interest rates have made a lesser impact there than in Europe and the US. The interest rate sensitivity (duration) of our ML Nordic High Yield investment basket is 0.4 and the return level after deduction of expenses is 5.5%.

The future

Keeping an eye on interest rate risk

The recovery of euro zone economies is in full swing. Reading between the lines of the ECB's communications, the current level of stimulus is no longer really necessary. At the same time, inflation expectations are cautiously rising and the growth in raw material prices is maintaining the chance that inflation prints will rise well over 2% this summer. The strengthening of the euro early on this year is slightly slowing down the price development of exports, but we do not expect the strengthening of the euro to alone undermine current economic development. Domestic demand has recovered and consumer confidence is rising while at the same time unemployment rates have been pushed down also in Southern Europe. In Germany, the unemployment rate has fallen to 5.4%, and on the labour markets, IG-Metall is pushing for a rise in wages of 6%, while employers are in favour of a 2% raise.

Inflation is always a secondary cycle element, which is why the ECB's super stimulus measures are beginning to appear past their sell-by date. The pressure for interest rates to rise is thus continuing and we have actively hedged against interest rate risk in our ML Fixed Income Portfolio investment basket in early 2018. At its lowest, interest rate sensitivity (duration) fell below one-year figures at the turn of January and February. As we see it, there is a particular need for active interest rate risk management as the downward trend in the interest rate level has been cut short in Europe. We do not necessarily see the interest rate level taking off on an upward trend immediately, but in any case, the amount of interest rate risk included in fixed income investments will hold a key role when achieving fixed income returns this year.

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Equities

Past situation

Strong start to the year

The equity markets featured a particularly strong start to the year as, on the one hand, investor sentiment in the US, driven by the country's tax reform, maintained demand after a successful 2017 and, on the other hand, the strong start to the earnings reporting season supported equities in fundamentals. The MSCI World All Country index rose +4.1% in January, which is the best start to the year in living memory. A large flood of assets hit the stock markets in January, particularly in ETFs (exchange traded funds). If these investments were to flow away quickly, it would destabilise the markets. Immediately at the start of the month, a significant correction occurred in the upward trend, which has driven itself upwards slightly too quickly in the US in our view. The surge in interest rates has also impacted the slight decline in equities.

The chronic decline in interest rates across the globe has provided support to asset classes world over; now this singular development has stopped and even turned around. The attraction of the emerging markets in equities continued at the start of the year and the best tempo was upheld by Brazilian equities (+11% in January) as raw material prices continued to rise. Also in Russia, the main index rose +11% to start off the year, accelerated by the same raw material momentum. Price volatility is normalising somewhat on the markets, which is basically a good thing. It is not normal for equities to continue rising as steeply as last year and in January, without any corrections.

Current situation

Earnings forecasts continue to be raised

Companies' earnings reporting began at the start of the year in the US. Earnings growth has been good and at the end of January when half of the S&P 500 companies had released their reports, earnings growth stood at around 15% (forecasts at some 11%). Earnings forecasts have been revised much higher in the early part of the year (+4%). Currently, the US expects to see very strong earnings growth, of around +15.7%, on the S&P 500 index. Also based on this earnings forecast, the S&P 500 index is factored in at a P/E of around 19x – the equity markets are thus not cheap by any means. The US GDP rose in Q4 at a year-on-year level of +2.6%, which included, however, a rise in consumer spending of +3.8% and growth in investments of as much as +7.9%.

The first comments on the impacts of the tax reform have been issued by US companies and some seem to be passing them on to their employees as one-time pay raises. Payroll development is on the Fed's radar at the moment with earnings level growth approaching 3% in the US. In Europe, earnings forecasts have been raised more moderately (approx. 0.4% in January) and the markets currently forecast +9.5% earnings growth for this year. Traditionally, the earnings season does not take off in earnest until February.

Europe has clearly remained more moderately priced as an equity market (Stoxx 600 P/E ratio some 15x with 2018 earnings forecasts). The possible continuation of the interest rate upsurge is gaining in significance due to the correlation between the equity and fixed income markets; hybrid funds have so far received support from the fixed income markets globally. However, the steepening of the yield curve (difference between short and long interest rates) traditionally supports the bank and finance sector together with rising interest rates.

The future

Volatility in equities set to rise

Equity market valuation levels have risen on the Western markets as the economic cycle develops. Even companies' earnings have improved but the recent brisk rise in interest rates has also raised valuation factors. The finale of the previous economic cycle began already in the mid-1990s in the US when it started to become clear that new technology will undoubtedly and permanently speed up productivity, as well as companies' earnings accrual. Equity indices' valuation factors rose on the Western markets to unheard of levels. A similar technological leap that would leave a lasting mark on productivity development is not necessarily currently on the horizon, however.

After the dramatic rise in equities in recent years, the market value of US equity indices in relation to GDP is now 150%, compared to 146% during 2000's technology bubble. Earnings forecasts have just been raised to extremely high levels, so it seems that there is a lot of good in prices in the short term. We expect equity price volatility to normalise from this cycle's bottommost figures early on this year.

In Europe, consumer confidence has risen rapidly, buoyed by economic growth, and confidence is currently approaching August 2000 levels. The wealth effects were at their highest following the equity markets' long upward trend, but comparatively, the European equity market is currently still far from the 2000 levels. European economic growth had taken off well and companies' industrial PMI is still 59.6 in the euro zone – indicating accelerating production levels. To start off the year, we have, however, remained in neutral position in terms of equity weight in our allocation products (read more in our Allocation insight).

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Alternative investments

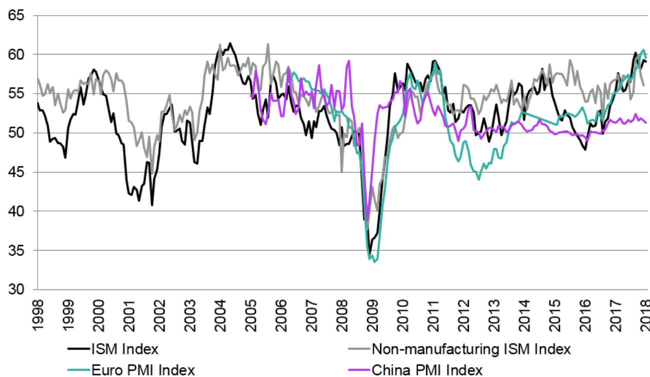
With regards to alternative investments, nothing new appears to be at hand. The low level of risk-free interest rates particularly in the euro zone is still driving investments to asset classes with no daily redemption opportunities. Thus, investors are looking for higher yields resulting partly from 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.

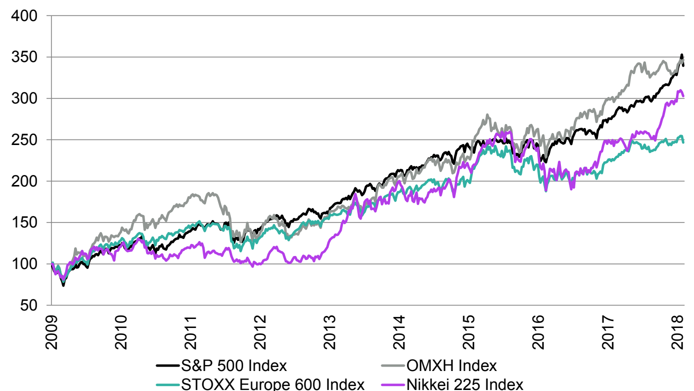
The private equity markets' valuation levels are nearing their all-time highest levels. The performance of private equity funds last started up at these valuation levels between 2006 and 2007 remained low once the financial crisis hit the markets in 2008. At the moment, the volume of investment capacity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

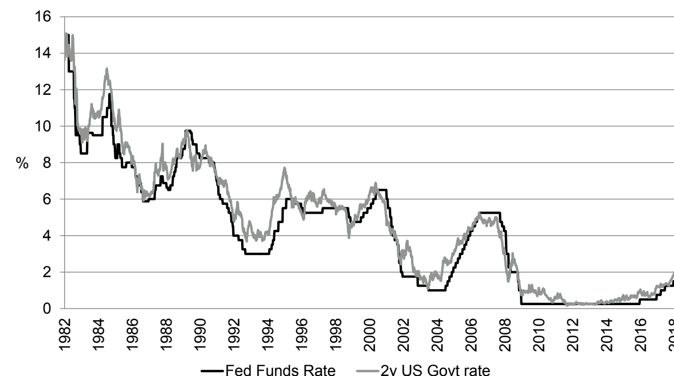
PMI development



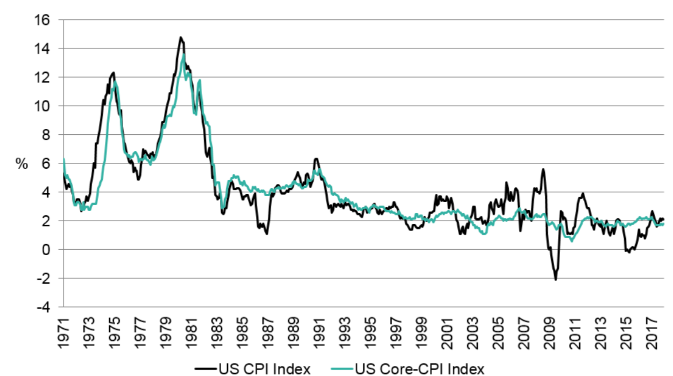
Equity indexes (2.1.2009 = 100)



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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Mandatum Life Insurance Company Limited • Postal address: P.O. Box 627, FI-00101 Helsinki, Finland • Registered office and address: Bulevardi 56, 00120 Helsinki, Finland • Business ID 0641130-2 • www.mandatumlife.fi