MANDATUM LIFE

Market Outlook

9.4.2018

Companies' confidence index peaks behind us – growth outlook still good

The current global economic growth situation anticipates +3.7% GDP growth for this year, but it seems that companies' best confidence index levels lie behind us. Obviously, the results of surveys cannot improve forever. The improvement in credit risk premiums correlates strongly with the actual return and activity, which is why they need monitoring. Companies' earnings growth outlook is still excellent: the US anticipates earnings growth of as high as 19.5% for this year. In our allocation products, the equity weight is currently close to neutral (read more in our Allocation Insight).

The money markets' operating environment will change dramatically this year when the central banks' ultra-light monetary policy ends. The Fed is actively reducing its balance sheet, in addition to interest rate hikes. It appears that the ECB will end its bond purchases in October and the first interest rate hike is factored in for the first half of next year. Smaller independent central banks will probably need to tighten their policies also, to avoid causing too much change pressure on the currency markets.

For now, real inflation has been moderate in the US and Europe, so central banks have shown moderation in pulling back from stimulus measures. In the US, the Fed's actions are clearly ahead of Europe, which has impacted the historically large transatlantic interest rate differential. It has a direct impact on the rise in the dollar's hedging costs from the perspective of European and Asian investors. At the moment, Europeans are annually paying approximately 3% in hedging costs against the weakening of the dollar.

Despite the very strong earnings growth and global economic growth outlook, equity market prices levelled out after the powerful upward surge last year. The operating environment is changing and the best figures in companies' confidence indices lie behind us. After the US corporate tax reform, up to 19.5% earnings growth is expected in the US S&P 500 index for this year and +8.4% earnings growth for Europe's Stoxx 600 index. On the emerging markets, earnings growth expectations lie somewhere between these two figures, at about +15%. The first act of the trade war is underway, played out mostly between the US and China. The Trump's administration sees itself as promoting the interests of Americans, but an extensive trade war would be in nobody's interest. Nervousness is thus the word of the day on the equity markets.

***Juhani Lehtonen**, Director,*
Fixed Income & Market Strategy
Investment Solutions

Market returns 30.3.2018

Fixed Income	Return 1 mth	Return 2017	Return 1 yr
JPM Money Mkt	0,0 %	-0,1 %	-0,3 %
JPM EMU Govt	1,6 %	1,5 %	3,4 %
Barcleys Infl.Linked	1,3 %	1,1 %	5,3 %
JPM Credit Index	0,4 %	-0,3 %	1,2 %
JPM High Yield	-0,2 %	-0,5 %	3,9 %
JPM GBI EM Divers. (LC)	0,2 %	2,0 %	-1,7 %
JPM EMBI+ (HC)	0,7 %	-2,0 %	2,2 %

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	-1,7 %	3,2 %	10,3 %
Euro Stoxx 50	-2,2 %	-3,8 %	-1,7 %
Stoxx 600	-2,0 %	-4,2 %	-0,2 %
S&P 500	-2,5 %	-0,8 %	14,0 %
Dow Jones	-3,6 %	-2,0 %	19,4 %
Nasdaq	-2,8 %	2,6 %	20,8 %
Nikkei (Japan)	-2,0 %	-5,0 %	15,7 %
Hang Seng (China)	-2,3 %	0,9 %	29,5 %
India	-3,5 %	-3,0 %	12,7 %
Russia (RTS)	-2,8 %	8,3 %	17,6 %
Brazil	0,0 %	11,7 %	31,4 %
MSCI Europe	-2,0 %	-4,3 %	-0,4 %
MSCI World All Country	-2,3 %	-1,9 %	11,2 %
MSCI Emerging Markets	-1,9 %	0,7 %	22,0 %
MSCI Latin America	-0,3 %	5,9 %	20,2 %
MSCI Eastern Europe	-2,9 %	3,4 %	17,1 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	2,2 %	2,2 %	13,8 %
Oil (spot)	5,6 %	7,4 %	24,9 %
Gold (spot)	0,3 %	1,0 %	4,4 %
HFRX Global HF	-1,2 %	-1,8 %	0,5 %

Foreign exchange	30.3.2018	28.2.2018
EURUSD	1,23	1,22
EURJPY	130,97	130,08
USDJPY	106,28	106,68
EURGBP	0,88	0,89
EURSEK	10,28	10,11
EURNOK	9,66	9,64
Interest rates		
Fed	1,75	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	0,50	0,66
iTraxx Europe 5y (IG)	59,87	52,47
iTraxx Crossover 5y (HY)	285,13	264,19

Lähde: Bloomberg. Mennyt tuotto ei ole tae tulevasta tuotosta.

Fixed Income

Past Situation

Selective approach to new issues

The escalation of price volatility in risky asset classes on the financial markets has also appeared below bonds with better credit ratings (BBB or higher), in high yield bonds. Credit risk premiums have risen somewhat, but, in the big picture, we are still very close to this cycle's lowest levels, with demand depressing return levels. Towards the end of last year, there was still demand for structured corporate bond risk. The final quarter of 2017 was exceptionally brisk on the European CLO (collateralised loan obligation) market with close to EUR 20 billion in new issues. Money is seeking better returns than what are available in bank accounts; however, it is worth bearing in mind the relationship between risk and the related returns. This is why we have been quite selective about new issues, also in terms of bonds and senior loans. In March, on the Nordic markets, we participated in our ML Fixed Income Portfolio in the issues of If P&C Insurance Company, Point Resource, Color Group and DNA. On the European senior loan markets (high yield issuers) return levels actually improved slightly. Floating interest rate coupons are a good feature of this market, so in connection with the rise in interest rates, interest rate risk might possibly not materialise in the same way as in fixed-coupon instruments.

In March, European high yield funds continued to experience investment outflows, but the rate has settled down somewhat compared to the start of the year. In our view, the Nordic high yield market is still an attractive alternative for fixed income investors, due to the nature of the floating rate instrument selection and good return level of about +5.5%.

Current Situation

The dollar's hedging cost is still rising

The interest rate differential between the US and euro zone is still widening. This can be seen directly also in the dollar hedging cost, which is around 3% for a 12-month period. The United States has issued even more short-term debt obligations to finance the budget deficit and, at the same time, Trump's tax reform is encouraging companies to repatriate their subsidiaries' financing to the United States, which will increase the offering of short-term commercial papers.

In the US, 3-month Libor rates have widened significantly compared to the federal funds rate, which is more technical in nature than a clear indication of increased uncertainty in the banking system. The rise in Libor rates compared to the federal funds rate has also traditionally served as an indicator of the functioning of the inter-bank markets and of the related risk. The rise in the Libor rate corresponds, in practice, with one additional interest rate hike, so it does have some significance in terms of the financial markets' tightness. At the same time as the dollar hedging cost is rising, foreign investors have begun to correspondingly reduce dollar-denominated bond investments. With less demand, also new issues in US corporate bonds with higher credit ratings have been around 10% lower than in the corresponding period last year, and credit risk premiums have widened somewhat during the first quarter. It is worth remembering that international foreign exchange reserves and institutional investors are major owners and buyers of US government bonds.

The cost of hedging the dollar is eating away quite a bit (approx. 3% annually) at Japanese yen-investors' US government bond returns. We are currently following with interest how the cash flows of international investors move on the US government bond markets. A spending strike would increase the pressure for interest rates to rise in the US.

The future

Central banks reducing stimulus measures

Inflation is currently low, which gives central banks room to unhurriedly withdraw from their stimulus policies. In Germany, inflation is rising gradually and March's +1.6% rise (annually) is not yet a problem to the ECB, with the figure for the entire euro zone at +1.4%. As we head toward summer, inflation is, however, rising on an annual level as a result of the weak figures in last year's comparison period. At the moment, the ECB's first interest rate hike is scheduled for the summer of 2019, which is also good timing according to Bundesbank. Smaller European independent central banks will have to go along with the ECB's timetable to avoid causing too much change pressure on the currency markets. Thus, also Sweden, Norway and the UK can expect a reduction in stimulus measures. The scheduling of the first interest rate hike in Sweden would strengthen the krona somewhat compared to the current level.

During this year, the European fixed income market and the corporate bond market will have to adapt once again to an operating environment that lacks a strong central bank buying interest on the primary and secondary markets. The markets will then be more on their own. This also benefits investors as, when return levels normalise with time, credit risk premiums will probably take the right path again. Therefore, we consider patience to be a virtue also on the fixed income markets and we do not currently consider the accumulation of cash in our portfolios as bonds mature to be a very big problem.

The European investment grade corporate bond market (credit rating BBB or higher) and the Italian government bond market have been the fixed income market sectors where the ECB's purchases have made the largest impact, relatively speaking. The normalisation of these markets will be the focus of a lot of interest as the year continues.

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Equities

Past situation

Tech shares under pressure to sell

In addition to the general softening of the equity markets, the markets have focused closely on the plummeting of US technology companies' stock prices, which had risen considerably last year. USD 500 billion in market value disappeared from major technology companies in March as a result of the more than 10% drop in stock prices. The correction, in and of itself, is still relatively small when compared to the upward trend of the past few years. For example, Amazon's stock price has risen by an impressive 375% since the start of 2015. The valuation factors of many technology companies' shares have become disconnected from reality, which is why a comparison with the situation at the start of the 2000s is relevant.

If a company's net sales are a few billion dollars and losses come to, say, one billion dollars a year, the dramatic rise in the share's price on the stock exchange is based, questionably, on an overly optimistic view of the future. Early-year fund redemptions from equity ETFs (listed funds) have calmed down slightly but price volatility in the main indices is significantly stronger than last year. The volatility in tech companies' stocks has caused the movements of the S&P 500 index to strengthen in the early part of the year. Share issues are selling worldwide and demand seems to be strong. It is obvious, however, that for some companies, issue valuations have been too high in light of the current earnings performance.

Finland has had some IPOs as well. Our fund that invests in Finland's equity markets participated in Harvia's and Altia's IPOs. It may be that after Rovio's issue and the resulting stock price decline, investors in Finland are slightly more cautious about participating in issues. In Europe, equity issues and subscription issues have been relatively plentiful and plummeting stock prices have been unavoidable. In addition, the nervousness related to news concerning the trade war has sunk the stock prices of many small cap companies significantly. Compared to the earnings development, equities have become cheaper, approaching the long-term average in Europe.

Current situation

Valuation factors become more moderate

After the increase in price volatility on the equity markets in the early part of the year and the downward surge in stock prices, Q2 took off with clearly more moderate valuation factors. In Europe, the broader Stoxx 600 index's 12-month forward-looking P/E ratio is approx. 14x and in the US the corresponding figure for the S&P 500 index is below 17x. Last year's earnings season was a success and Q1 earnings reporting has started up in the US. We are still in a situation where a record earnings-per-share growth of as much as +19.5% is expected for this year for S&P 500 companies.

Europe is looking at a somewhat calmer outlook, but even here the Stoxx 600 index earnings growth forecast for this year is still +8.4%. The outlook for companies has become slightly more moderate following a slight cooling off of PMIs, but we are still nicely above the critical level (50), which indicates the growth of production. After the US tax reform, earnings forecasts have been raised rapidly and the bar is undoubtedly high if we consider the possibility that companies on average could defeat this year's earnings growth market expectations. Still, in the big picture, US companies are doing well and, in practice, the economy is operating in a full-employment scenario. In light of the most recent surveys, companies' investment appetite in the US is rising, which is a positive signal.

Globally, earnings forecasts are still being raised, so, at least for now, the threat of a trade war has not affected market forecasts. It has, however, affected the daily price volatility of equities, which means that the Q1 earnings reports are arriving at a good time as companies are able to communicate their outlook to the markets. The fact is that stock prices have fallen at the same time as earnings forecasts have been raised.

The future

Volatility in equities rising

Companies have barely changed their operations – instead the surrender of equities is continuing at a brisk pace in the US. It is a significant driver for the equity markets, together with earnings development. The final rounds of the economic cycle in the US have offered most companies the opportunity to refinance the interest rate level of loans. In addition, the balance sheets of companies are at a relatively good level and debt has been extended further into the future. For example, in the US, the S&P 500 index's traditional EBITDA to debt ratio (net debt per EBITDA) is currently at a 1.48x level. The markets also forecast that it will decline over the next 12 months to around 1.2x.

It is important to bear in mind that debt ratios are being raised dramatically precisely in the national economy. It currently seems that the US budget deficit is growing to 5% in relation to GDP while the current account is in deficit. Twin deficits and the country's debt-fuelled stimulus at this stage of the economic cycle are a rare combination, even historically speaking – and not entirely unproblematic. It is possible that in the US the already red-hot economic growth (+2.5% rate currently) will overheat significantly and the central bank will have to calm the situation with rising inflation expectations. The rise in interest rates will finally end the strengthening of the economic cycle, as is traditional. There is still a long way to go before this happens, however, but it is important to keep this risk in mind.

Europe's economic cycle is clearly lagging behind the US. The central bank is only just finalising its stimulus policy and taking its foot off the gas this year. The euro zone, led by Germany, has a clear surplus and the strengthening euro is definitely impacting the export outlook. The escalation of the global trade war would not leave Europe a bystander – it would have a clear impact on many export sectors. Similarly, the smaller Asian economies would suffer due to the slowing of global trade. For the time being, this is not factored into market forecasts, instead, also in Asia, companies' earnings forecasts have been raised and +14% earnings growth is predicted due to global GDP growth of +3.7% (read more in our Allocation Insight).

Alternative investments

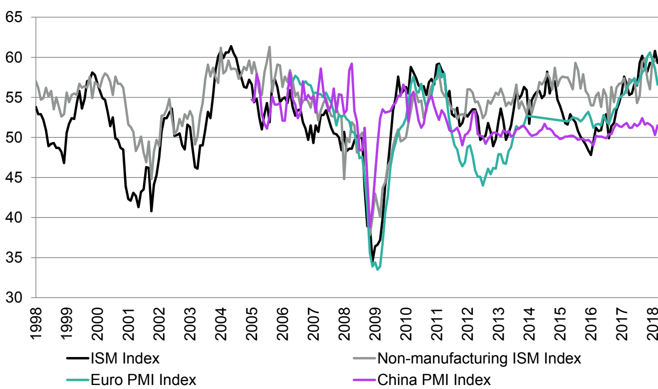
With regards to alternative investments, nothing new appears to be at hand. The low level of risk-free interest rates particularly in the euro zone is still driving investments to asset classes with no daily redemption opportunities. Thus, investors are looking for higher yields resulting partly from 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; the volume of investment capacity is still at the end-of-2015 level. 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. In our view, as a whole, the market situation is still relatively positive for private debt investments, from the perspective of long-term investors, particularly compared with traditional asset classes.

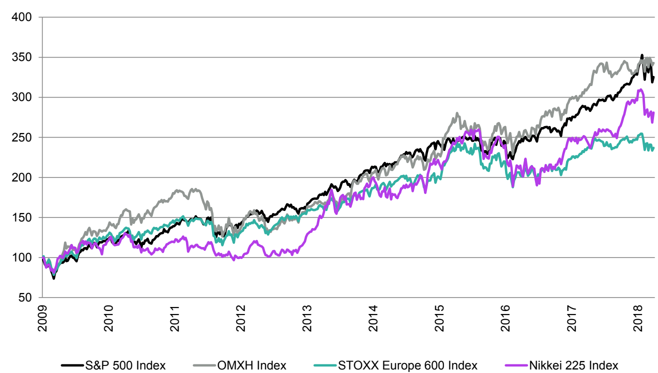
The private equity markets' valuation is at its all-time highest levels. The performance of private equity funds last started up at these valuation levels between 2006 and 2007 remained low once the financial crisis hit the markets in 2008. At the moment, the volume of investment capacity in private equity funds is at an all-time record level and we have made new investments extremely selectively. Investments have only been made in those parts of the markets in which we see less competition. For example, instead of traditional buyout investments, we have made investments in Nordic growth funds. The same applies if we consider a manager to be especially skilled at making successful investments in a more difficult environment.

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, we are focusing on investments in so-called value add and loan-form properties where we still see good return potential and which are less sensitive to changes in the capital markets.

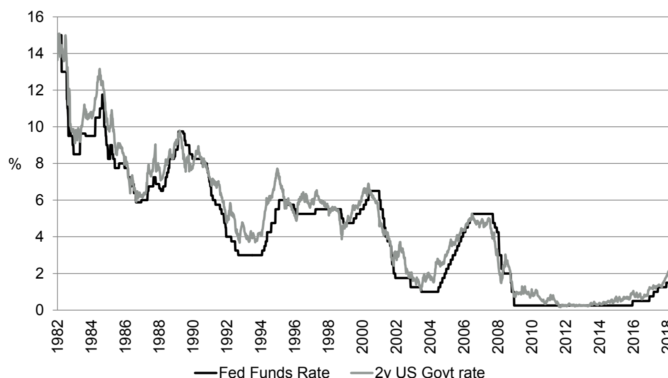
PMI development



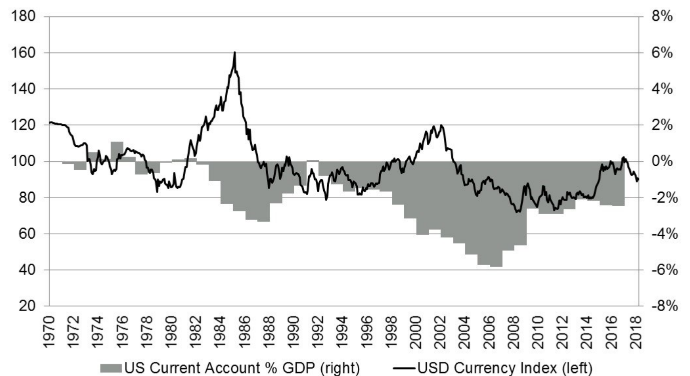
Equity index development (2 Jan 2009 = 100)



US Fed's key interest rate and US 2-year government bond interest rate level



US current account % of GDP and USD index



Source: Bloomberg. Historical performance is not a guarantee of future performance.

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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