MANDATUM LIFE

Market Outlook

22.5.2018

Record-breaking earnings season for US companies

Economic growth is still strong globally and this year's GDP growth forecast is +3.7%. Asia's growth is even accelerating slightly and the US has achieved full employment. Also in Europe, growth is going strong and is likely to reach approx. +2.3% this year. The recent appreciation of the dollar and continued rising of interest rates in the US are, however, causing overcast skies in many EM countries with a deficit. Companies in Western countries are doing exceptionally well, nevertheless, and in the US, the Q1 earnings season has been historically strong – earnings growth compared to a year earlier has been as high as +23%. Read about the positioning of our allocation products in the current situation in our Allocation Insight).

The continued rising of interest rates in the US is the result of strong economic figures and moderately growing inflation pressure, fuelled by rising wages. The Fed already raised its key interest rate once this year and prices have factored in three more interest rate hikes for this year. The US 10-year government bond rate is already more than 3% and with shorter rates, including the 2-year, already at 2.5%, the difference between long-term and short-term government bonds (i.e. the yield curve) has levelled out as short-term rates have risen more than long-term rates. This type of flattening of the yield curve has been, historically speaking, one of the best (if not the best) indicators of an upcoming economic downturn. Earlier, when a yield curve has become descending (i.e. short-term rates higher than long-term rates), this has very accurately predicted an economic downturn.

In Europe, the situation is different with short-term rates undeniably in negative territory and long-term rates still subdued (2-year swap rate –0.12% and 10-year swap rate +1.02%). The ECB will not begin winding down its securities purchase programme until towards the end of the year and is thus two years behind the Fed in its key interest rate policy.

The earnings reports for this year's Q1 started up in April and the average earnings growth in the US has been a whopping +23%, or thereabouts, compared to the previous year. At the same time, GDP growth for the first quarter was +2.3% in the US, in line with forecasts. However, the same phenomenon can be discerned as in Europe: individual economic figures have already fallen slightly behind expectations in the US as well, which means that the surprise indices will no longer rise. This is serving to keep the equity markets moving laterally.

Europe's GDP growth stayed at +0.4% in Q1 but growth of around +2.3% is still expected for this year. The earnings season has been more subdued in Europe than in the US with recorded earnings growth of around +5%. Q1 earnings growth on the emerging markets compared to a year earlier has been approx. +14%. The fact is that an earnings season as strong as this is likely to remain one of the best in US history. The bar will be set fairly high for Q1 of next year. All in all, for this year, the forecast is some +20% earnings growth for S&P 500 companies, which is a very strong level.

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Market returns 30.4.2018

Fixed Income	Return 1 mth	Return 2017	Return 1 yr
JPM Money Mkt	0,0 %	-0,1 %	-0,3 %
JPM EMU Govt	-0,4 %	1,1 %	2,4 %
Barcleys Infl.Linked	0,1 %	1,1 %	4,2 %
JPM Credit Index	-0,1 %	-0,3 %	0,7 %
JPM High Yield	0,7 %	0,1 %	3,8 %
JPM GBI EM Divers. (LC)	-1,2 %	0,7 %	-2,3 %
JPM EMBI+ (HC)	-1,5 %	-3,5 %	-1,5 %

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	5,8 %	9,2 %	11,1 %
Euro Stoxx 50	5,8 %	1,8 %	2,0 %
Stoxx 600	4,5 %	0,1 %	2,3 %
S&P 500	0,4 %	-0,4 %	13,3 %
Dow Jones	0,3 %	-1,6 %	18,1 %
Nasdaq	0,1 %	2,7 %	18,1 %
Nikkei (Japan)	4,7 %	-0,5 %	19,3 %
Hang Seng (China)	2,5 %	3,5 %	30,0 %
India	6,6 %	3,4 %	19,0 %
Russia (RTS)	-7,6 %	0,0 %	8,4 %
Brazil	0,9 %	12,7 %	31,7 %
MSCI Europe	4,6 %	0,1 %	2,4 %
MSCI World All Country	1,8 %	0,0 %	11,8 %
MSCI Emerging Markets	1,2 %	1,9 %	20,6 %
MSCI Latin America	2,4 %	8,5 %	22,2 %
MSCI Eastern Europe	1,0 %	4,4 %	15,0 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	5,0 %	7,3 %	22,1 %
Oil (spot)	5,7 %	13,5 %	35,5 %
Gold (spot)	-0,6 %	0,4 %	2,4 %
HFRX Global HF	-0,2 %	-2,0 %	0,1 %

Foreign exchange	30.4.2018	30.3.2018
EURUSD	1,21	1,23
EURJPY	132,05	130,97
USDJPY	109,34	106,28
EURGBP	0,88	0,88
EURSEK	10,57	10,28
EURNOK	9,68	9,66
Interest rates		
Fed	1,75	1,75
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	0,56	0,50
iTraxx Europe 5y (IG)	54,41	59,87
iTraxx Crossover 5y (HY)	271,07	285,13

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

Fixed Income

Past Situation

Selective approach to new issues

Euro zone growth has continued to be relatively strong in Q1. In Germany, the GDP has grown by +0.3%, and in Finland, GDP growth provided a positive surprise at +1.1%, bringing the annual level to +3.1%. The ECB's stimulating policy supports economies and keeps financing costs at a low level, which also benefits SMEs.

The increase in the price volatility of risky asset classes in the spring also made a mark on the corporate bond markets. Credit risk premiums have slightly widened (the company-specific credit risk premium has thus grown) but in the big picture we are still close to this economic cycle's bottom-most figures, i.e. the tightest credit risk premium levels. To us investors this means selectivity, as all companies that have been able to have sought financing and are now locking it in at current levels. From the economic cycle perspective, companies' activity in locking in low financing costs can also be interpreted as a positive phenomenon, but for investors it means a selective approach. They must carefully weigh the risk-return ratio with returns at a relatively low level.

In Europe, the current index level return on the high yield markets is 3.1% (yield-to-worst, YTW), which was some 2% at its lowest at the end of last year. In our ML Fixed Income Portfolio we have bought in April and May, for example, some of BEW's, Rettig's and TVO's bonds in new issues. A more positive situation is still afoot on the Nordic high yield markets, with the current return level in our ML Nordic High Yield investment basket, for instance, at some 6% and practically without interest rate risk, with the underlying investment volume mostly subject to floating interest rates. In Europe, the rise in interest rates has not yet materialised as it has in the US, so, in our view, it is worth focussing on the management of interest rate risk.

Current Situation

Yield curve flattens in the US

The markets are currently keeping a close eye on the rise in US government bond rates as well as the flattening of the yield curve. The yield curve means the return levels of bonds of different lengths, such as government bonds, and their difference. Often it deals with the spread between the 2-year government bond and the 10-year government bond. As of the start of 2017, in the US, the flattening of this yield curve has been significant. In earlier economic cycles it has been one of the most important indicators of an approaching economic downturn.

When a central bank tightens the monetary policy in the face of inflation pressure, short-term rates often rise faster compared to long-term rates. This is how the yield curve becomes flat or shallower. At the moment, the 2–10-year interest rate differential in the US is 0.55%. The fixed income markets are thus factoring in the growing likelihood of a downturn occurring in the US economy within the next few years.

Inflation expectations are still relatively moderate but payroll development and the rise in raw material prices are a sign of rising inflation in the US. Simultaneously, in accordance with the IMF's COFER data, the dollar positions of investors investing in reserves in US government bonds have narrowed even further. Japanese investors have turned into net buyers of US government bonds, as, after currency hedging, they fail to reach the level of the currency-hedged German government bond euro yield. Similarly, in the US, issues of short-term debt obligations of less than a year have been accelerating in order to finance the budget deficit.

The yield differential between the US Libor rate and government bonds (T-Bill), for now, describes a situation specific to the US rather than a general lack of confidence in the banking sector, of which a global widening of the Libor interest rate differential would be a sign. All the same, it seems that there is a large offering of US government bonds on its way while bonds from the secondary markets are also becoming available. Someone needs to buy these to make sure yield levels remain stable. If buyers fail to show up, interest rates will continue to rise.

The future

Central banks reducing stimulus measures

In the euro zone, the confidence index for companies was 55.2 in April, which is still well in line with +2.5% GDP growth. The low level of inflation in the euro zone is currently the factor that keeps the ECB in favour of a stimulating policy. The inflation rate in the euro zone in April was only +1.2%. The further expansion of the interest rate differential between the US and Europe is a good example.

The Fed has plenty of work cut out for it in reining in inflation expectations and gradually reducing the balance sheet while the ECB's foot is still on the stimulus pedal. The most recent labour cost index figures from the US show a rise of more than +3% annually in labour costs as a whole, of which payrolls make up the largest share. According to the Fed's latest comments, inflation is currently close to its target (2%) and, in addition, inflation risks are symmetrical. This can be understood to mean that the Fed would allow some sort of acceleration of inflation above this 2% target without a more forceful tightening of monetary policy. It can thus be considered likely that there will be key interest rate hikes, but at the same time, the Fed is aware that the levelling out of the yield curve would mean that the likelihood of a downturn occurring would increase, and it does not wish to encourage this by hiking the short-term key interest rate too quickly.

The government bond markets are also beginning to move in the euro zone with the interest rate on Italy's government bonds rising due to a more populistic government. The euro crisis in 2011–2012 is still fresh in people's minds and statements by Italian politicians about forgiving debts are not exactly resonating with the markets. Growth can be expected in the yield levels of Southern European government bonds, led by Italian government bonds. The ECB's secondary market purchases will end, according to our insight, in September–October 2018 and the greatest impact has been felt specifically on the Italian government bond markets. It is very likely that the bottom-most figures on the Italian government bond markets have been seen this cycle. We do not currently hold any euro zone government bonds in our fixed income portfolio.

Equities

Past situation

Yield differences growing between indices

During the spring, equity market price volatility has grown and clear yield differences have formed between different stock markets. Where last year's stock price development was very uniform, there are already significant differences within Europe for instance. Germany's DAX index has, after mid-May, returned +1.2% from the start of the year while in France, CAC40 has risen +7.5% and OMXHEX +13%. Sector-specific differences explain these movements more than any country-specific factors. The earnings of raw material, technology and consumer companies have been strong and bank and financial names have shown weaker earnings development all round. The valuation levels of many new technology companies' stock prices are still "challenging", to put it nicely. However, at the index level, P/E levels (valuation level, price per earnings development) have not rocketed skywards. In fact, at the moment, the S&P 500 index is currently the subject of an approx. 16x forward-looking 12-month earnings forecast, which is close to the long-term average.

On the emerging markets, earnings growth has been good with recorded earnings growth of some +14% in Q1. The strengthening of the dollar and the rise in US interest rates have simultaneously weakened the outlook for many EM countries with a deficit and in need of foreign financing. Argentina has, once again, been negotiating with the IMF on its debt limit, while last year, investors were still lining up to invest in Argentina's 100-year government bond. Situations shift fairly rapidly, as always. Also in Turkey, the macro economy is degrading and there seems to be no end to the lira's depreciation. The rise in the US interest rate level is currently being impacted by the first serious infection from the EM countries, with EM currencies already weakening. This gives EM countries' export companies a long-term positive boost but, in the short term, the situation is challenging.

Current situation

The earnings season is breaking records in the US

Earnings reports for Q1 of this year are, pretty much, in the bag in the US. Earnings growth has been the strongest this economic cycle with earnings per share improving for S&P 500 companies, in total, by up to +23% compared to Q1 of last year. The decline in corporate tax is likely to boost earnings growth percentages for this year in the US, which means that the bar for next year will be set higher. Investors need to be aware of this. For this year, the markets expect earnings growth of more than +20%.

By contrast, in Europe, earnings growth has remained +5% compared to Q1 last year, but companies are more confident in the future than earlier in this economic cycle. Many companies referenced the strengthening of the euro as a weakening factor in connection with their earnings. In our ML European Small & Mid Cap equity product, the latest purchases have been more from the consumer sector than anything else at the moment in Europe.

In Finland, earnings growth in the OMX Helsinki Cap index has been +4.7% compared to Q1 last year and approx. +6.7% without Nokia. Neste, UPM and Stora Enso all reported strong results, of which the forest industry was supported by the price of pulp in particular, which rose to this cycle's highs. Significant growth in the prices of raw materials is behind us on a general level as well, and, together with strong final demand, it provides companies the opportunity to raise the prices of end products. Inflation pressure is still well under control in the euro zone and no significant liquidation has been seen as yet. Globally, earnings growth is thus in progress in all the major economic areas, which is a sign of good final demand.

The future

Equities remain relatively attractive

The valuation level of equities in the US has become somewhat more moderate during the early part of the year. The decline in stock prices has merged with earnings forecast hikes and thus the valuation level is currently 16x (forward-looking P/E) on the S&P 500 index. Following a strong earnings season, forecasts have also been raised for this year and the focus has, once again, shifted to Q4: will companies be successful in maintaining the current earnings improvement momentum? So far, things look good.

Buybacks of treasury shares by companies have been a major factor supporting the equity markets, also in this upward cycle, and purchases are continuing. Fuelled by strong earnings development, companies are using their profits to buy back their treasury shares and, this year, this sum could rise to a total of up to USD 800 billion. As equity market volatility has risen, many funds relying on systematic investment strategies have already sold off some of their equity risk and their positioning on the markets is currently more neutral than before. With continued strong economic growth, the attractiveness of equities has not been challenged to any great extent.

Short-term rates are already starting to approach the equity return levels of the S&P 500 index but after the buybacks of treasury shares (and their retirement), the adjusted equity return level is still better than the government bond return in the US. What raises eyebrows about the United States' situation, is how the budget deficit is being increased at this point of the economic cycle. It is almost unheard of for the economy to be stimulated at this point by increasing government expenditure, with unemployment at 4% or less. Twin deficits (budget deficit likely to grow to 5% of the GDP and the trade deficit approx. 2.5%) have, historically speaking, proven to be a bad mix for any currency. Currently, this applies to the US dollar.

Alternative investments

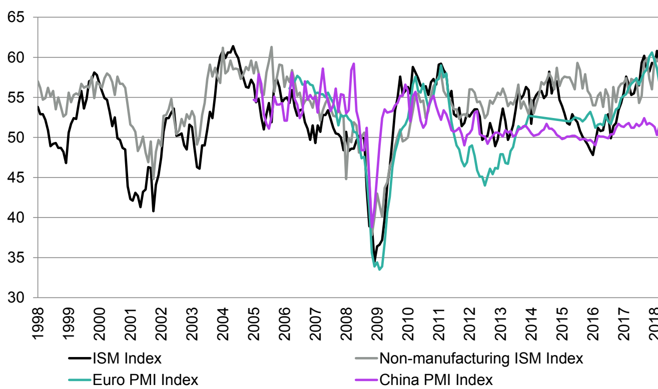
With regards to alternative investments, nothing new appears to be at hand. The low level of risk-free interest rates particularly in the euro zone is still driving investments to asset classes with no daily redemption opportunities. Thus, investors are looking for higher yields resulting partly from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

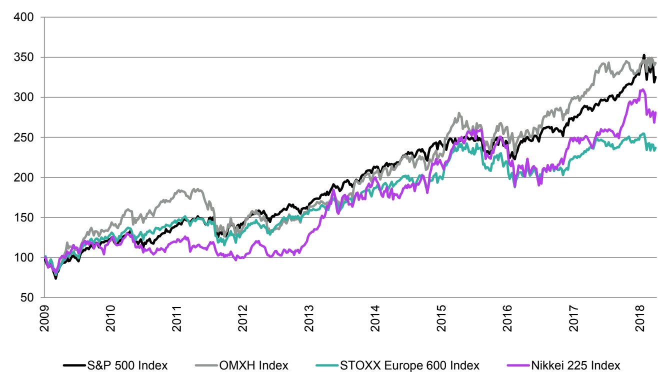
The private equity markets' valuation is at its all-time highest levels. The performance of private equity funds last started up at these valuation levels between 2006 and 2007 remained low once the financial crisis hit the markets in 2008. At the moment, the volume of investment capacity in private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

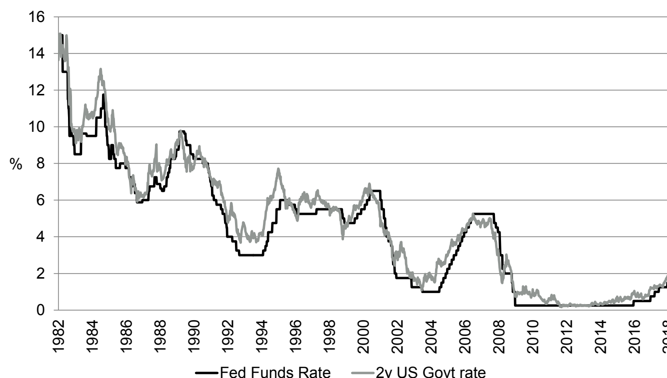
PMI development



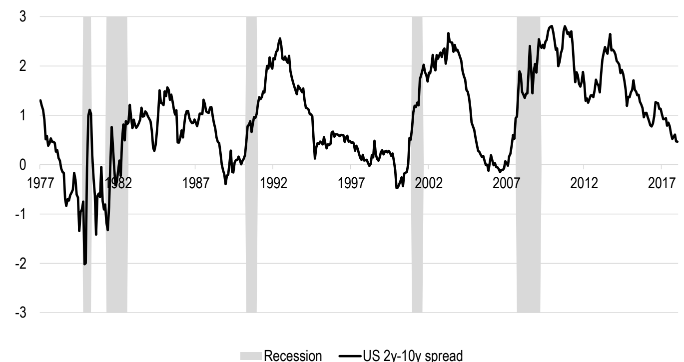
Equity index development (2 Jan 2009 = 100)



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



US Government 2y-10y Yield Spread



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

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