

Market Outlook

October 2018

Equities noticeably cheaper

Halfway through October, the equity markets experienced a significant downward correction practically throughout the world's main stock markets. The slight dwindling of economic growth, the calming down of trade flows and the uncertainty caused by the trade war have contributed to the sales pressure on equities.

All in all, the Q3 earnings season met with expectations in the US; earnings growth is approx. +20%, which is still very good. In Europe, China and the emerging markets, equities that are usually sensitive to economic cycles have shown weak development this year and the prices of many equities have fallen significantly. Assuming that the global economy does not plunge into a downturn and earnings growth conditions do not weaken to any great extent, many equity markets are clearly having a sale. Read more about the positioning of our allocation products in the current situation in our [Allocation Insight](#).

The upward pressure on longer-term low-risk government bonds has settled down in the euro zone and relented slightly also in the US. The monetary policies of the major central banks have not provided any surprises in recent weeks. In the US, the Fed is continuing with its interest rate hikes and we predict that the central bank will decide on a 3% key interest rate hike in this rate-hike cycle. In Europe, in turn, the ECB is ending its net purchases on the bond markets at the end of the year

and will move over exclusively to reinvestments when bonds mature in the balance sheet. So far, the ECB has offered no comment on the weighting of reinvestments (long vs. short bonds). This twist element has been used successfully by, for instance, the Fed, with the US forced to boost its economy once again after its net purchases. The first interest rate hike by the ECB is expected in September or October 2019, meaning that short Euribor rates are anticipated to remain negative for months to come.

The euro bank system, generally speaking, still seems to be experiencing massive overliquidity. There is plenty of money on hand. According to our projection, Sweden's first interest rate hike will occur in December this year and Norway has already carried out its first hike for this cycle. Of the major central banks, only Japan is behind the ECB in terms of interest rate hikes. Currently, within fixed income investments, we favour floating rate corporate bonds and, generally speaking, a proactive approach to interest rate risk management.

The US equity markets hurtled their way up to their all-time highest peak in late September but in mid-October experienced their first major correction since January-February this year. In the wake of sales pressure, this year's equity returns fell by more or less half in the US. The earnings season is underway and companies' earnings have remained very positive in the US. Compared to a year earlier, earnings

growth is looking to end up at approx. +20%. However, companies have been moderate in their comments and cautious in their trade war communication. Next year, earnings growth of some +10.5% is projected for S&P 500 companies. In Europe, more profit warnings have been given and comments have been even more cautious than in the US. Earnings growth of +9.2% is forecast for Stoxx 600 companies for next year, which will probably be revised slightly downward as the Q3 earnings season moves forward.

Earnings growth expectations for EM countries for next year are still around +11.8%, which is fairly high. China's growth forecast is calming down and interest rate levels in EM countries are rising in order to tackle the depreciation of currencies. The United States' main front in the trade war is China and, unfortunately, there does not appear to be a quick solution anywhere in sight. The protectionist measures are impeding and slowing down global trade flows and the impacts can already be seen on a wider scale. The investment appetite of companies is usually one of the best indicators – based on earnings comments, it is waning slightly at the moment. Nevertheless, global economic growth is in good shape, at a current growth rate of around +3.6%.

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Market returns 30.9.2018

Fixed Income	Return 1 mth	Return 2017	Return 1 yr
JPM Money Mkt	0,0 %	-0,2 %	-0,3 %
JPM EMU Govt	-0,1 %	-0,5 %	0,1 %
Barclays Infl.Linkd	-0,1 %	-0,8 %	0,9 %
JPM Credit Index	-0,5 %	-0,4 %	0,1 %
JPM High Yield	-0,1 %	0,0 %	0,7 %
JPM GBI EM Divers. (LC)	2,8 %	-5,0 %	-5,7 %
JPM EMBI+ (HC)	2,8 %	-4,7 %	-5,0 %

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	-0,7 %	12,3 %	11,0 %
Euro Stoxx 50	0,3 %	-0,6 %	-2,9 %
Stoxx 600	0,3 %	0,9 %	1,5 %
S&P 500	0,6 %	10,6 %	17,9 %
Dow Jones	2,0 %	8,8 %	20,8 %
Nasdaq	-0,7 %	17,5 %	25,2 %
Nikkei (Japan)	6,2 %	7,8 %	20,8 %
Hang Seng (China)	0,0 %	-4,1 %	4,4 %
India	-6,2 %	7,4 %	17,1 %
Russia (RTS)	9,5 %	7,4 %	10,1 %
Brazil	3,5 %	3,8 %	6,8 %
MSCI Europe	0,5 %	0,8 %	1,5 %
MSCI World All Country	0,5 %	5,5 %	11,1 %
MSCI Emerging Markets	-1,2 %	-2,9 %	2,7 %
MSCI Latin America	1,9 %	2,8 %	4,8 %
MSCI Eastern Europe	4,5 %	12,6 %	16,6 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	3,9 %	11,8 %	22,9 %
Oil (spot)	5,6 %	24,7 %	42,0 %
Gold (spot)	-0,9 %	-10,3 %	-8,6 %
HFRX Global HF	-1,0 %	-3,6 %	-2,8 %

Foreign exchange	28.9.2018	31.8.2018
EURUSD	1,16	1,16
EURJPY	131,93	128,84
USDJPY	113,70	111,03
EURGBP	0,89	0,90
EURSEK	10,32	10,60
EURNOK	9,45	9,73

Interest rates	28.9.2018	31.8.2018
Fed	2,25	2,00
ECB	0,00	0,00
BoJ	-0,10	-0,10
BoE	0,75	0,75
Euribor 3m	-0,32	-0,32
Euribor 12m	-0,16	-0,17
Germany10y	0,47	0,33
iTraxx Europe 5y (IG)	68,81	68,26
iTraxx Crossover 5y (HY)	273,78	299,32

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

Fixed Income

Past Situation

The return levels on Italian government bonds rose sharply at the very end of September and during October, with the country's government about to pass a budget with a larger-than-expected deficit, aiming at a deficit of -2.4% compared to the GDP. It is entirely possible that when euro zone growth settles down next year, we will be approaching the -3% Maastricht criteria again, which means that confidence in Italy is once again being shaken. The markets have begun to factor in Italy's carryings on and the resulting problems.

When the ECB's net purchases are concluded at the end of this year, also on the Italian government bond markets, the Boot must find new real market-based buyers for its government bonds. The ECB's QE purchases and the banks' LTRO-financed purchases have corresponded with close to 80% of Italy's government bond issues. Statements in which government representatives proclaim that a return to Italy's own currency would solve almost all of Italy's problems do

not resonate well with euro government bond investors.

Ratings agencies are monitoring the situation and the downgrading of the credit rating from investment grade would further disrupt the search for buyers. In October, Moody's downgraded Italy's rating to just one step away from high yield, to Baa3. Italy's debt amounts to around EUR 2,300 billion (approx. 130% per GDP), so a possible high yield status would cause the majority of government bond investors to sell off some of their holdings, in other words Italy's interest rates would rise even further. The previous time that Italy fell outside market financing was in autumn 2011, after which the ECB's measures basically saved Italy and got it back onto the bond markets. Italy's uncontrolled interest rate surge after the conclusion of the ECB's net purchases would be an immensely negative trend for the euro zone.

Italy still hitting headlines

Current Situation

Simultaneously, with the Southern European government bond and corporate bond markets congested after the summer, the Nordic corporate bond markets have experienced good momentum on average. Very few new issues have been made since the Q3 earnings season began, so investors have accumulated cash to invest.

As of the start of the year, the Nordic high yield market has been doing unbelievably well (approx. +5%) compared to the European high yield market, which is just below zero from the start of the year. This can be explained partly, but not entirely, by the amount of interest rate risk (sensitivity to interest rate changes). Credit risk premiums are still wider in the Nordics but especially the amount of interest rate risk (0.4-year duration) is just a fraction of the euro markets'. The net increases in the ECB's balance sheet purchases will discontinue at the end of the year and a gradual normalisation of credit risk premiums is to be expected on the European IG market (credit rating BBB- or better).

The normalisation of the interest rate level itself will likely take several years but a small rise in underlying rates will quickly push the return on IG bonds into the red and the buffer on European high yield bonds is nothing to write home about either.

In the US, on the other hand, the interest rate is well on its way upwards and, combined with the credit risk premiums on IG companies, corporate bonds offer a real option to the calculated dividend yield on equities. In the US, the volume of IG issues is roughly USD 1,000 billion since the beginning of the year, which is just over 6% slower than last year's rate. The rise in interest rates explains the somewhat more subdued issue rate. From the euro investor perspective, the challenge of dollar-denominated investments stems from currency hedging costs, which are approaching a 3% annual level at the moment. Without open currency risk, the return on US fixed income investments will dry up to similar levels as on the euro markets.

Nordic high yield markets going strong

The Future

The Fed's key interest rate hikes will continue according to schedule. The interest rate last rose in September and the next one-quarter per cent hike is scheduled for December. We predict that the Fed will reach a 3% key interest rate level this cycle. The labour market situation is still tightening in the US and, based on September's statistics, the unemployment rate fell to 3.7%, its lowest level in 48 years.

The essentially full employment situation is raising inflation pressure with the leading indicators for payroll development speaking in favour of approx. 3.5% pay pressure. For now, realised inflation has remained in check and the rise in interest rates has correlated more with strong economic figures. In the G3, core inflation, less energy and food, has risen to just +1.4%. Inflation is always a late-cycle element, which is why the central banks' interest rate hikes quite often eventually put an end to the economic cycle. The situation is currently not alarming despite President Trump's criticism of the Fed. Real interest rates are still

low in the US although the key interest rate has been raised a number of times. No major movements have been discerned in inflation expectations based on market pricing. The tapering of the Fed's balance sheet is also proceeding as expected.

The Fed's interest rate hikes, the rise in US market rates and the appreciation of the dollar are an unfavourable combination for many EM countries. On the EMD markets (EM government bonds), interest rate levels have risen briskly as the central banks of the countries most critically dependent on foreign financing (Turkey, Argentina, South Africa etc.) defend their weakening currencies with key interest rate hikes. In our view, there is no rush to enter the EMD markets at present. Better opportunities can be found in Nordic high yield bonds.

Central banks scaling down stimulus measures

Equities

Past Situation

US stock indices reached new peaks within this cycle and yield differences compared to the European and EM stock markets have remained large, even historically speaking. The last time EM stock markets fell at the current rate was in 2013 when US long-term interest rates rose during the taper tantrum period. The tightening of the trade war to focus solely on the US and China has affected international trade flows, and on the local markets of Asian stock exchanges, export companies have suffered the most. Midway through October a major correction took place in practically all of the key stock indices in the midst of the new Q3 earnings season.

This year's stock market development is complex because, also in the US, a significant proportion of the rise in the main indices is reliant on a few major technology companies (Apple, Amazon and Microsoft). When a sell-off wave (i.e. taking in profits, with the lead of systematic investors) was achieved in tech company stock prices at long last, other more traditional industry sector stocks were not able to buffer the decline. The

same was observed in Finland where the drivers have been a few companies from more traditional sectors (Neste, Fortum, UPM and Nokia).

Following the course correction from the equity markets, the S&P 500 index was valued at 15.4x based on the earnings forecasts for 2019. Equities have thus become clearly cheaper. The corresponding P/E for the Stoxx 600 index in Europe was 12.5x with the earnings forecasts for 2019. The correction was significant, which is supported by the profit warnings of European companies. In Europe, especially Italy's banking and financial sector has been under pressure. Italian banks, together with the central bank, are some of the largest owners of Italian government bonds, which means that the rise in government bond interest rates weakens the earnings at market value. For instance, the P/B ratio of Unicredit has fallen to 0.46. Despite this, the markets are still very positive concerning Italian equities with +11% forecast for next year's earnings growth for the MIB index. The fate of the Italian banking sector depends largely on the fate of the country itself.

US markets still the top performers

Current Situation

The third quarter earnings season took off in the US and earnings and earnings forecasts remain strong. Currently, earnings growth is some +20% compared to a year earlier, which is still a very strong level. Sales growth has been good at approximately just under +8%. The question is: are we at the peak of the cycle also in terms of earnings, i.e. can the earnings growth rate accelerate any further? The bar is set high for next year and a much calmer earnings growth of approx. +10.4% is predicted for S&P 500 companies for 2019, which is also an extremely good level. In the long run, the key condition for the continuation of a rise in stock prices is earnings growth and, for now, earnings growth and earnings forecasts are not showing any clear signs of weakness in the US. The impacts of the US-China trade war are currently being assessed through the analysis of companies' Q3 earnings taking place world-

wide.

This year on the Asian markets Chinese companies with significant US trade connections have performed worse than even China's heavily weakened stock markets. When we look, as a whole, at China's exports to the US in terms of the export products affected by tariffs, the growth in exports has halted entirely compared to a year earlier. The tariffs have thus had a fairly clear and rapid impact on trade between the US and China. China cannot respond with equally large tariffs in dollars, but the US automotive industry, for instance, is very dependent on Chinese components, so countermeasures are most likely in store. China has also stopped buying US oil and turned to other oil-producing countries. Tariffs and the trade war are diverting trade flows at an accelerating rate.

Q3 earnings season underway

The Future

The stakes are rising as the economic cycle moves forward. The US corporate tax reform in early 2018, in addition to one-time tax-cuts, provided a major boost to the repatriation of dollars to the US. Now, however, this repatriation flow is cooling down. Companies have also continued to buy back their treasury shares in the US. Currently, the annual rate has exceeded the previous peak in 2007. A diminishing of this purchase rate is to be expected, however, over the next quarters.

The United States' strong economy and repatriated dollars have also maintained a high rate of M&A activity. The value of M&A deals has risen to a record level, at more than USD 3.3 trillion from the start of the year. Which is a lot. The US economy is still experiencing practically full employment and confidence in the economy is strong across the board. The ISM index for the US service sector just reached its peak this cycle at 61.6. Within this, the employment component rose to its 20-year peak (62.4).

The difference between the US economic momentum and the rest of the world also correlates strongly with this year's equity market development. EM stock markets are at their cheapest levels in years

in relation to the US stock markets. However, supposing that the US were to impose duties on all Chinese imports to the US, the impact on China's GDP would be considerable. China's government has attempted to stimulate the economy at the same rate as the consumption of households declines. Macro indicators are weakening in China and GDP growth in Q3 remained at +6.5%. Sales of cars and other consumer discretionary items are falling in China but construction starts are still more than 15% above year-on-year levels. The Chinese government also has a lot of opportunities to stimulate demand, but at the same time it has to ensure that the indebtedness of households does not become too high. With China's export growth dwindling, domestic consumption is the main growth engine. China has become the main opponent in the trade war and the stakes are rising.

Despite the present risks, our insight is that, in this economic cycle and due to the current earnings growth rate, the equity markets still offer better prerequisites for a rise in value than low-risk fixed income instruments.

China turning out to be main opponent in US trade war



Alternative Investments

With regards to alternative investments, no developments are at hand. The low level of risk-free interest rates particularly in the euro zone is still pushing investors towards asset classes with no daily redemption opportunities. This way, investors are looking for higher returns resulting partly from this weaker liquidity and the related liquidity premiums. This is well-suited to many investors' portfolios.

By early 2018, the investment capacity in European private debt funds had not, in the light of statistics, risen much above the earlier levels, but this development has changed, and the amount of dry powder has significantly increased and has ended up at a clearly higher level. New investment opportunities are steadily emerging in the private debt markets with, for instance, the tightening of banks' regulation framework opening up new opportunities for investors. Typically, a growing volume of

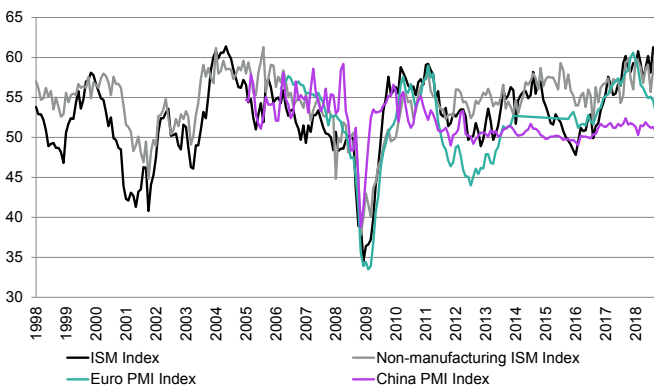
investment capacity increases competition for good investments and makes it harder to discover them. In our view, as a whole, the market situation is still favourable for private debt investments, from the perspective of long-term investors, particularly compared with traditional asset classes.

On the private equity markets, valuation levels are at an all-time high. The performance of private equity funds last started up at these valuation levels between 2006 and 2007 remained modest 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 continued to be extremely selective in making new investments. Investments have only been made in those parts of the markets in which we see less competition. Instead of traditional buy-out investments, we have made investments in Nordic growth funds, or if we con-

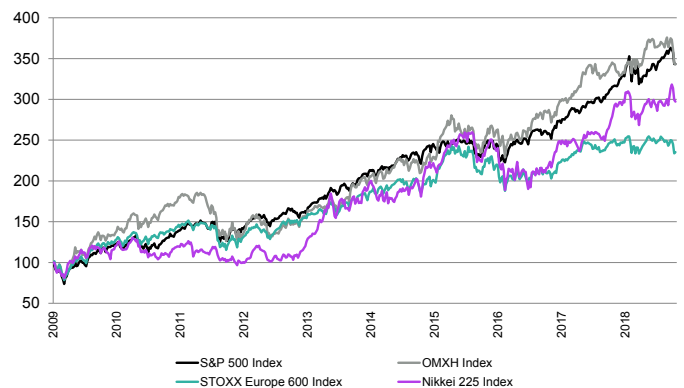
sider a manager to be especially skilled at making successful investments also in a more difficult environment.

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.

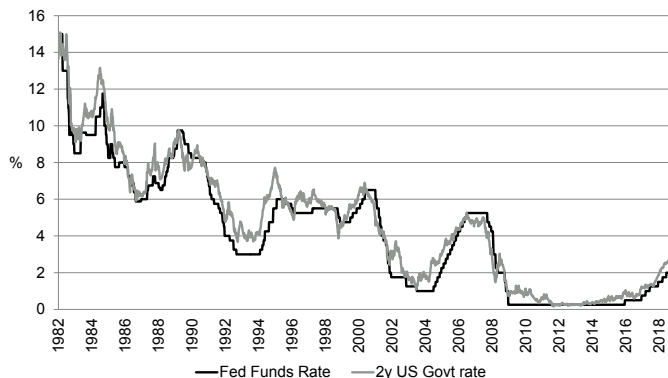
PMI Development



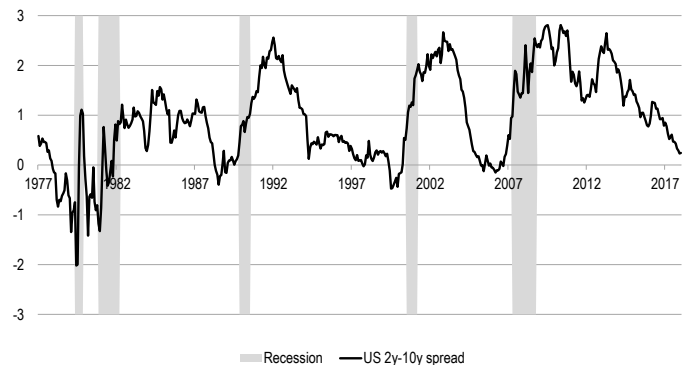
Equity Index Development (2 Jan 2009 = 100)



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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