Allocation Insight

7 September 2017

Yield expectations on all liquid asset classes are reflecting the ultra-low interest rate level. As a result, the future return on both fixed income and equity investments will most likely remain clearly below the levels that we have been accustomed to in recent years. If we additionally assume that the risks impacting the economy and companies' business do not deviate from the norm – in other words the economy remains cyclical – risk management will rise to the fore in the current situation.

Companies' earnings growth is slowing and valuation levels are elevated

In addition to improved general economic activity, the main reasons for the very positive earnings growth among Western companies this year have been the recovery of the earnings of energy and financial sector companies from the 2015–16 earnings downturn. The earnings of energy sector companies suffered due to the dramatic decline in oil prices but, because the oil price recovered a year ago and settled at around 50 dollars, it has been possible to adapt business operations and improve the earnings level. Financial sector earnings are, on the other hand, tied to the general interest rate level and the rise in interest rates year-on-year has supported the earnings growth of companies in the sector, especially in Europe. The recovery of earnings growth in both sectors is largely behind us and no similar factors or sectors are in sight that would maintain the current earnings growth level in the West. Changes in earnings forecasts seem to have turned downwards (Figure 1), however, and in this type of environment, stock prices do not typically rise dramatically.

Stock price valuation levels are additionally high compared to the long-term averages (Figure 2). This can be explained based on the low interest rate level but, with monetary policy most likely to be tightening, it is unlikely that the stock price will rise mainly based on a rise in the valuation level (as in 2012–2014).

Geopolitical risks, which are growing, do not historically cause permanent changes in the functioning of the economy. Politics, on the other hand, dictates the economy's rules and bad decisions can have long-term impacts. Many political decisions are expected to be made in September, not least of all in the US.

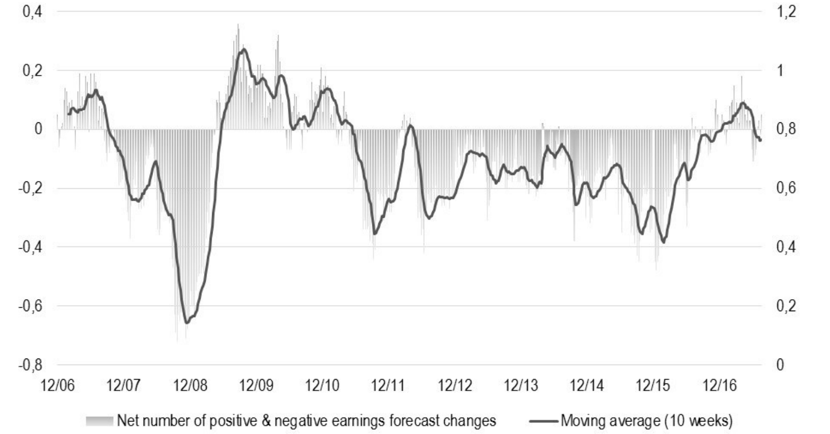
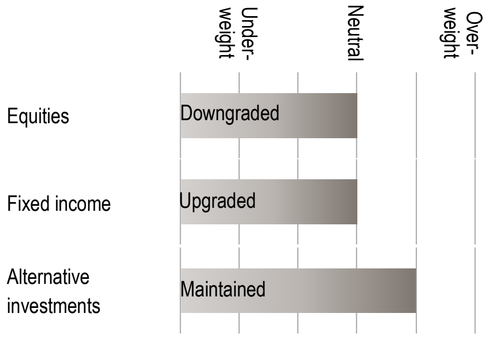
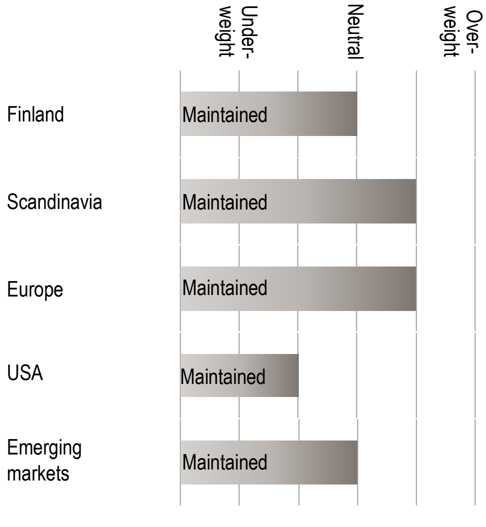


Figure 1: Development of global equity markets and number of positive and negative earnings forecast changes 12/2006–9/2017. Source: Bloomberg.

Asset classes



Equities



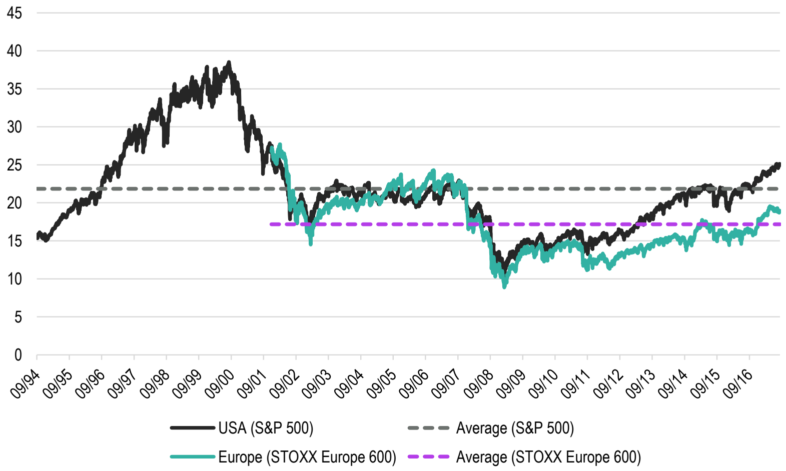


Figure 2: Normalised P/E ratio on the Western markets 9/1994–9/2017. Source: Bloomberg.

We are downgrading equity risk but are maintaining a neutral position

In allocation solutions, we downgraded the weight of equity investments by six per cent at the end of August. The change was carried out by selling investments in global small cap companies. Taking the above-mentioned factors into account, we wished to use the change to decrease the portfolios' capital risk and sensitivity to stock price fluctuations – however in a way that would allow the portfolio's return expectations to remain at a moderate level. The change also reflects our Group's insight into the capital markets.

Despite an asymmetrical risk outlook, the equity markets have a positive vibe. Companies' earnings power level is encouraging and their ability to pay dividends is good. Investing is about making relative choices and the overall compensation paid for risk taking is still clearly higher than interest income. Therefore, the portfolio's equity-fixed income allocation remains in neutral position.

In fixed income investments, we continue to favour corporate bonds and the volume of cash is up

Fixed income investment credit risk premiums have remained at low levels although, mainly due to political reasons, price volatility rose in August. We have been cautious and selective in making new investments due to which the cash weight is still rather high. No significant changes have taken place in inflation expectations and realised inflation is also still below the central banks' target in both the US and the euro zone. Expectations concerning the normalisation of monetary policy in the US and the gradual winding down of stimulus in the euro zone are likely to maintain pressure on the interest rate level to rise, but it seems that the schedule for starting the winding down process will be delayed.

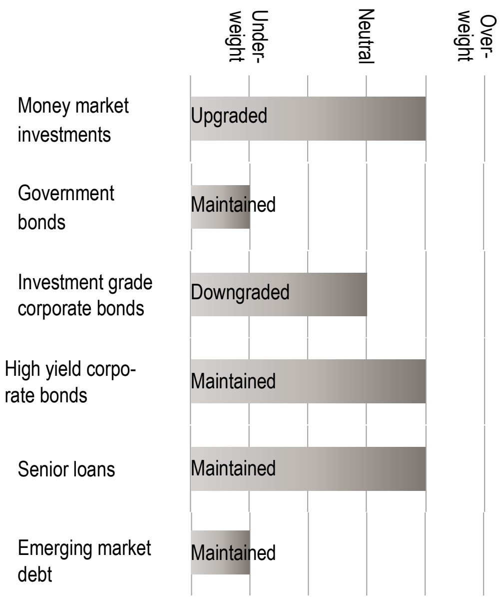
In fixed income investments, the focus is on Nordic corporate bonds. The fixed income investments' interest rate risk, measured in duration, is more moderate than the market index, as a result of which the performance of fixed income investments has been weaker than the market index as interest rates fell in late summer. We have maintained the hedging ratio against dollar risk at around 75 per cent.

Building of alternative investment portfolio moving forward

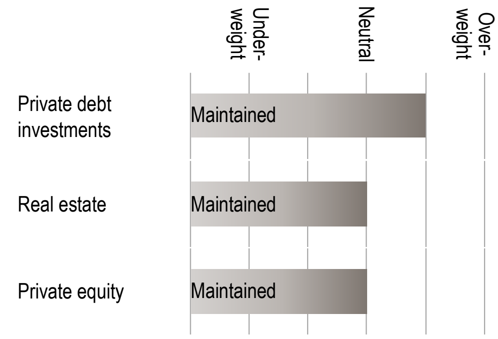
In alternative investments, we made a co-investment in the *Broad Street Real Estate Credit Partners* fund. The fund invests its assets in direct real estate loans in the United States. The investment commitment rate for alternative investments is around 70 per cent.

The return expectations of alternative investments clearly exceed the return on liquid fixed income investments, which is why we weight alternative investments at the expense of fixed income investments in our asset allocation.

Fixed income



Alternative investments



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