MANDATUM LIFE

Market Outlook

7 September 2017

Earnings season wound up successfully – equities still under scrutiny

Equities moved horizontally in August following a successful second-quarter earnings reporting season. The earnings season went well in the US, Europe and the emerging markets alike. The continued weakening of the dollar has, however, gnawed away at yields on the US equity markets from the euro -investor's perspective (S&P 500 index from the start of the year -0.6% in euros vs. +11.9% in dollars).

Price volatility rose on the equity markets in August from its multi-year bottom and the allocation of new assets in equity funds in Europe and the US fell somewhat. We will maintain the weight of the equity markets at neutral in our allocation but we have downgraded our equity weight slightly after the summer.

Interest rates began to fall once again in August with risk appetite experiencing a few hiccups to compensate. The yield level on Germany's 10-year government bond fell back down to +0.36% and the yield on the US 10-year bond fell to +2.12%. The expectant mood on the fixed income markets continues with news on the winding down of the balance sheet stimulus programme anticipated from the central banks over the next few months, and with high demand on the corporate bond markets still pushing credit risk premiums towards the tight levels preceding 2007. A relatively large amount of assets can still be found in cash globally, with investors maintaining a good-sized cash buffer in hopes of broader yield levels.

In Europe, the ECB's stimulus programme is still in control on the corporate bond markets and we expect information in September or October on the timing of the reduction of the QE programme scheduled to begin next year. Similarly, in the US, the Fed is expected to report in October, at the latest, at what pace it intends to reduce its balance sheet. We do not foresee any major market impacts in the short term, but in the long run it is a well-known fact that growing the balance sheets of central banks has correlated strongly with good return development in risky asset classes.

The equity markets stood still in August in the Western markets but emerging market stock markets continued to rise. A successful Q2 earnings season is behind us and, in the short term, many factors other than the basic fundamentals are currently driving the equity markets forward. The tightening of geopolitics in Asia and the challenges linked to the raising of the debt ceiling in the US have kept investors on their toes in August. In the long term, the valuation levels for the equity markets are at their most expensive for the current cycle. On the markets, expectations for the continuation of positive earnings growth are discernible in prices. Earnings growth of +11% is predicted for next year on the S&P 500 index in the US and earnings growth of more than 12% for the broad European Stoxx 600 index.

In the real economy, GDP growth prerequisites continue to be positive globally: central banks are continuing their stimulus measures, interest rates are low, consumer demand is at a good level and no significant inflation pressure is in sight. There is, however, reason to keep an eye on the overall equity market set-up against elevated valuation levels now that increased political risks are the main topic of conversation on the markets.

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

Market returns 31 August 2017

Fixed Income	Return 1 mth	Return 2017	Return 1 yr
JPM Money Mkt	0,0 %	-0,2 %	-0,3 %
JPM EMU Govt	0,8 %	0,2 %	-2,6 %
Barcleys Infl.Linked	0,8 %	0,0 %	-0,5 %
JPM Credit Index	0,7 %	0,9 %	-0,6 %
JPM High Yield	0,4 %	4,7 %	6,4 %
JPM GBI EM Divers. (LC)	0,9 %	1,7 %	2,9 %
JPM EMBI+ (HC)	1,9 %	8,8 %	3,4 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	-0,8 %	-6,9 %	2,6 %
Oil (spot)	-6,0 %	-13,6 %	-4,3 %
Gold (spot)	3,8 %	14,5 %	-0,4 %
HFRX Global HF	-0,2 %	1,9 %	2,9 %

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	0,5 %	10,6 %	18,5 %
Euro Stoxx 50	-0,7 %	6,3 %	16,1 %
Stoxx 600	-0,8 %	5,8 %	11,8 %
S&P 500	0,3 %	11,9 %	16,2 %
Dow Jones	0,7 %	13,0 %	22,3 %
Nasdaq	1,4 %	20,3 %	24,7 %
Nikkei (Japan)	-1,3 %	3,8 %	18,5 %
Hang Seng (China)	3,1 %	31,3 %	26,7 %
India	-2,3 %	20,5 %	13,0 %
Russia (RTS)	8,8 %	-1,5 %	19,6 %
Brazil	7,5 %	17,6 %	22,3 %
MSCI Europe	-0,8 %	5,5 %	11,9 %
MSCI World All Country	0,4 %	11,4 %	16,2 %
MSCI Emerging Markets	2,1 %	23,0 %	21,8 %
MSCI Latin America	4,5 %	16,8 %	18,0 %
MSCI Eastern Europe	5,2 %	1,6 %	16,2 %

Foreign exchange	31.8.2017	31.7.2017
EURUSD	1,19	1,18
EURJPY	130,98	130,57
USDJPY	109,98	110,26
EURGBP	0,92	0,90
EURSEK	9,46	9,55
EURNOK	9,24	9,31
Interest rates		
Fed	1,25	1,25
ECB	0,00	0,00
BoJ	-0,10	-0,10
BoE	0,25	0,25
Euribor 3m	-0,33	-0,33
Euribor 12m	-0,16	-0,15
Germany10y	0,36	0,54
iTraxx Europe 5y (IG)	55,43	52,45
iTraxx Crossover 5y (HY)	237,76	234,08

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

MANDATUM LIFE

Fixed income

Past Situation

Inflation remains low

The inflation level took a nose-dive again in Europe and the US in August, when risk appetite dwindled temporarily. The interest rates on Germany's government bonds fell along the yield curve and also swap rates were falling. Inflation has been surprisingly moderate in the euro zone and the US.

The latest core inflation rate in the euro zone was just +1.2% on the annual level and broader inflation was +1.5%, when at the same time, in the US, broad inflation was +1.7% at the annual level. Thus central banks on both sides of the Atlantic were not in any great hurry to adjust their monetary policies in a tighter direction. Actually, at the moment, the timing of the Fed's interest rate hikes in terms of the next hike has moved to next year.

Similarly, the ECB has indicated in its recent comments that the winding down of the QE programme will advance at a leisurely pace. We predict, however, that during the next few months, the ECB will announce that it will reduce its purchases to some EUR 40 billion per month from the start of next year. The Fed is also expected to announce to the markets its timetable for reducing its balance sheet.

Direct market impacts are likely to remain small over the short term but the fact is that someone else needs to buy the current government and corporate bonds from the markets in order for the markets to remain at their current level. The Italian government bond markets and the euro zone's highest-credit-rating corporate bond and mortgage loan markets are markets where the ECB's support purchases make the biggest relative impact. We are monitoring these markets carefully over the autumn.

Current Situation

Credit risk premiums remain tight

Demand for corporate bonds continues to be high on the fixed income markets as the ECB pushes forward its own balance sheet stimulus programme purchases at the same time as end investors still appear to have plenty of cash in anticipation of higher yield levels. August was very quiet on the corporate bond issue front, which was ideal for tightening credit risk premiums on the secondary markets. In Europe, the credit and default rates are falling and the level in August was 2.4 per cent. The credit rater S&P forecasts that credit defaults would fall to around 2 per cent in Europe in March 2018. In the United States, corresponding levels are slightly higher due to the energy sector's credit defaults, but they are also falling. At the moment, the US is at 3.3 per cent and, based on S&P's forecast, next March's level will be 2.8 per cent.

All in all, investors should be prudent on the credit risk markets and carefully consider any new investments. We have been wary of tying down too much cash at the current tight credit risk levels as demand is high and, resulting from the central bank's purchases, the market situation is clearly manipulated in the European corporate bond market with the highest ratings (investment grade). What illustrates this clearly, is that, because of the higher level of underlying interest, the United States' 10-year government bond interest rate (i.e. yield level for investors) is 2.1% while, at the same time, the yield level for the European high yield corporate bond market cash index with a lower credit rating is 3.1%. This reflects the distortion of the European interest rate level due to the ECB's ultra-light monetary policy but also the low level of credit risk premiums.

In our view, it is worth having sufficient cash to ensure that, when credit risk premiums widen for some reason or other, there is enough dry powder for the most important reinvestments.

The Future

US debt ceiling needs raising

According to the Ministry of Finance, the last chance for raising the US debt ceiling is on the 29th of September. On the fixed income markets, the yield on the US's short-term debt obligations (T-bills) have now significantly widened from the 29th compared to normal (+0.2%), as a result of which the markets are keeping a close eye on political debate.

The horrific devastation caused by Hurricane Harvey may serve to ease the situation, however, as debt ceiling negotiations would seem politically irresponsible in this situation. We do not expect to see a repetition of 2011 when the markets momentarily lost faith in the ability of the US to finance itself on the government bond markets. Instead, we expect the Fed to announce the schedule for reducing its balance sheet but, for the markets, the short-term impacts will likely be small. The US is almost the only large government bond market where the interest rate level has somehow normalised. At the moment, more than 30% of global government bond index bonds are already, in terms of returns, equipped with minus signs to begin with, which poses quite a dilemma. The negative interest rates on German, French, Swedish and Japanese and other short and medium-term government bonds will straighten out in the future when the central banks' stimulus measures are removed due to positive inflation. Thus, in the fixed income markets, significant negative figures are expected in the long term in portfolios with government bonds at the index level.

We consider the significance of interest rate risk management to be underestimated at the moment on the markets. The normalisation of the interest rate level will take time, however, and we may not experience any significant rising of interest rates this year. The impacts of rising interest rates will be seen on a broad scale in the pricing of all asset classes and, in light of the demand situation on the current markets, it seems that they have not prepared for this scenario.

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

MANDATUM LIFE

Equities

Past Situation

Europe outperforming the US this year in euros

The upward momentum of equities settled down in August once general risk appetite gave way following a successful earnings season. No major changes have been made to earnings forecasts in the aftermath of the second quarter earnings season; if anything, global forecasts have been slightly raised with Japanese companies taking the lead.

On the currency markets, the continued weakening of the dollar in August has eaten away at the return on the US equity markets from the euro investor's viewpoint (dollar risk open without currency hedging) and at the end of August, the result on the S&P 500 index was already negative (–0.6%) as of the beginning of the year. In dollars, the S&P 500 index has yielded well from the beginning of the year at +11.9%. The Stoxx 600 index in Europe has risen +5.8% as of the beginning of the year and SMEs even higher.

The attraction of the emerging markets has not yet received a knock; the main markets in Latin America and Asia's stock markets have benefited from the perking up of global economic growth and a successful earnings season, with the rise in raw material prices adding some wind to their sails. Brazil's main index has risen from the start of the year by as much as +17% and as a whole the MSCI Emerging Markets index by +23%. The weakening of the dollar and fall of dollar interest rates have also stimulated many emerging market companies in the short term through the financial markets.

In China, the growth outlook has not experienced any dramatic changes; the central government is still pursuing GDP growth of some +6.5%. China's Party Congress in October will add some clues on China's objectives for the next few years while the Hang Seng index is still zooming along ahead of the major EM stocks at an annual growth rate of +31 per cent.

Current Situation

Earnings season over – other drivers on the equity markets

The final remnants of the Q2 earnings season were revealed in August and, as a whole, the earnings season went well. Globally speaking, after the earnings season, companies' earnings forecasts for this year were even raised. In the US and Europe, earnings forecasts were raised slightly in August, which was an extremely positive indication that economic growth is gaining ground. Earnings improvements in the raw material and energy sector compared to a year earlier played a major role, but other sectors also delivered positive results.

In Q2 of this year, for the first time in years, all of the main sectors in Europe even reported positive earnings performance compared to a year earlier. S&P 500 companies are projected to reach approximately +11% earnings growth and a similar earnings growth percentage next year. In Europe, the corresponding figures for the broad Stoxx 600 index are +12.8% for this year and a more moderate +8.6% for next year. The strengthening of the euro in summer 2017 has slightly depressed the forecast momentum in Europe and, if the euro were to strengthen more against the main currencies, export sector companies could expect further decline in earnings forecasts for the autumn. Right now, currency movements are one of the main drivers, in addition to geopolitical and other political developments, in terms of the geographical earnings performance of stocks.

For now, there appear to be no significant new elements in store for the growth outlook so, in that sense, we do not expect any major new developments in earnings forecasts in upcoming months. The stimulating position of the central banks continues but schedules concerning the reduction of stimulus measures are expected in the autumn. This is significant for risky asset classes in the long run.

The Future

Cheap money feeds M&As as autumn progresses

A low interest rate level and the lowest credit risk premiums this cycle partly served to boost M&As. According to many surveys, CEOs' confidence in the economy and the positive performance of their own companies were at the highest this cycle, supported by companies' PMIs. M&A activity is around 30% more brisk in Europe than a year ago and more is in store.

Private equity funds, on the other hand, have become more active than ever in arranging share issues of their holdings, which means that signs of an overheating economic cycle are starting to manifest. However, when observing economic growth, it seems that companies are currently turning out good earnings in Western countries and sector-wise growth is widespread. Central banks' stimulus measures are maintaining the prerequisites of economic growth and inflation is not a problem at the moment.

In the US, the more stimulating national financial policy pushed for by Trump has not yet managed to get more wind in the country's sails and hardly any of Trump's larger projects have, as yet, materialised. Talk of a renewal of tax policies has, however, been rumoured. Based on the most recent comments, there are plans to reduce corporate tax from 35% to 15%. At the same time, a type of repatriation programme for off-shore profits at a very low one-time tax rate would be created to repatriate American companies' offshore profits back to the United States.

The reduction of taxes is, basically, positive for the equity markets, but corporate earnings are impacted by a host of other issues. In the big picture, we see reason to be careful in terms of equity risk and we have somewhat reduced share weights in our portfolios after the summer, nevertheless maintaining our neutral position.

Alternative Investments

With regards to alternative investments, no major changes have occurred. The low level of risk-free interest rates globally and particularly in Europe is still driving assets to asset classes which do not have daily redemption opportunities and in which the investor's return requirement is higher partly due to weaker liquidity.

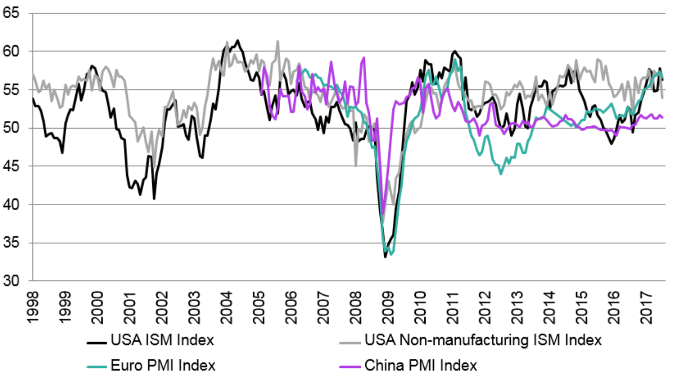
Globally, a lot of cash is available in private debt funds, but the amount has not grown recently, instead remaining at the end-of-2015 level. New investment opportunities are steadily flowing onto the private debt markets with, for instance, the tightening of banks' regulation framework opening new material up to investors. The yield levels on the more illiquid private debt bonds have not changed very much globally in recent years. The market situation is still relatively positive for the Mandatum Life Private Debt I and II portfolio, from the perspective of long-term investors.

The private equity markets' valuation levels are starting to be at their all-time highest levels, which is why we are making private equity investments very selectively at the moment.

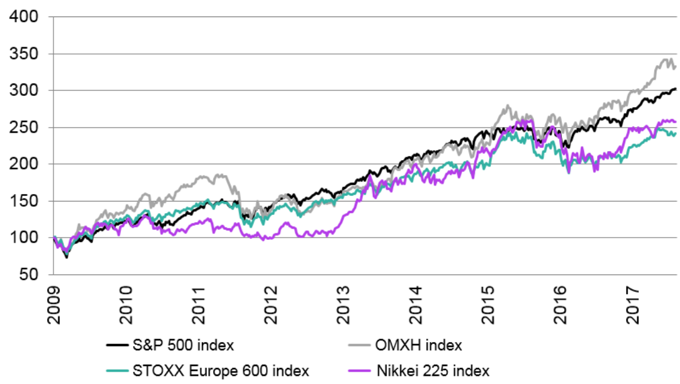
On the European real estate markets, yields on so-called core properties (e.g. central office properties in major cities with long-term lease contracts) have fallen to their all-time lowest level due to high demand and the low interest rate level. Due to the low yield levels of the core investments and the related investment timing risk, we are currently focussing on value add strategies and real estate investments in the form of loans.

On the raw material markets, Hurricane Harvey did away with a quarter of the United States' oil refinement capacity and the price of gasoline rose significantly towards the end of August. The resulting inflation pressure will likely remain short-lived. The price of oil has remained within a relatively narrow variation range but the positive momentum of the global economy has clearly raised the prices of industrial metals (copper, zinc etc.) after the summer.

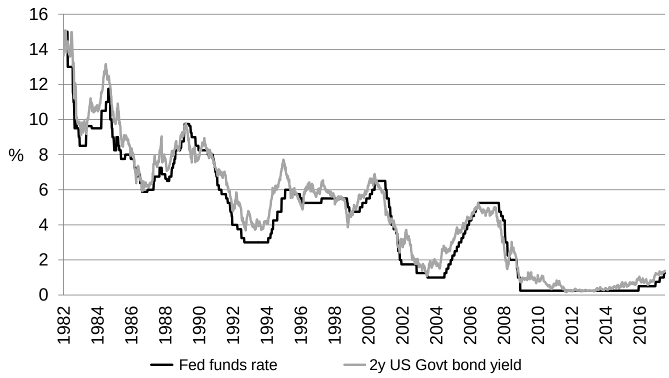
PMI development



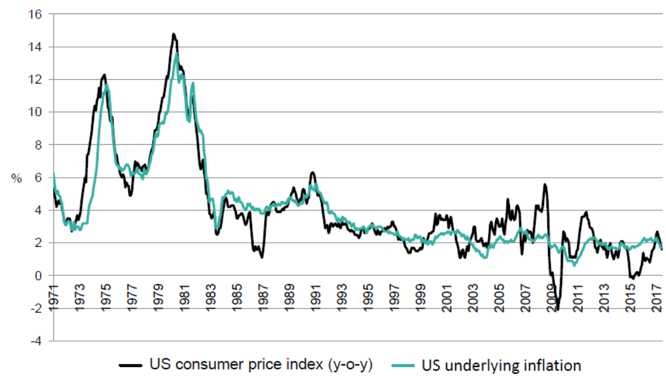
Equity indexes (2.1.2009 = 100)



Fed funds rate and 2y government bond yield



US consumer price index and underlying inflation



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