MANDATUM LIFE

Market Outlook

19.6.2018

Another leak in the Boot

Global economic growth has continued at a good level, and this year's GDP growth forecast of +3.7% still appears realistic. In the US, growth is regaining momentum, as indicated by higher PMI levels, for example. With China in the lead, growth in Asia also remains on the right track, at around +5.2%. However, the strong economic growth seen across the globe faced some headwind through the European financial markets, due to Italy's government crisis. Italy's interest rates spiked, reminding people that political intricacies might easily further interfere with the euro zone's future prospects. Indeed, credit risk premiums have been wider in June than in May. Read about the positioning of our allocation products in the current situation in our Allocation Insight.

Low-risk government bond rates quickly took a downward turn at the end of May as a result of the problems in forming Italy's government. The euro crisis of 2011–2012 is so recent that the markets are hypersensitive to everything that could be construed as a plan to exit the euro. US government bond rates also fell due to declining risk appetite. The rise of Italian government bond rates is no trivial matter. Italy's debt to GDP ratio is a massive 130%, and the interest rate level peaking at more than 7% in November 2011 in the midst of the euro crisis banned Italy's access to market financing. Now, at the end of May, Italy's shorter-term government bonds momentarily peaked at over 3% and long-term bonds at close to 4%. With Italy's banking sector being a major owner of Italian government bonds, valuation losses are to be expected. As for corporate bond markets, credit risk premiums are widening (yield levels rising) as the ECB prepares to wind down its stimulus programme. A low interest rate level and widening credit risk premiums create a more difficult fixed income market environment for this year. That is why we think that active management of interest rate risk and credit risk plays a key role.

First-quarter corporate earnings season ended on a high note. US companies' earnings rose as much as +25% from the previous year (S&P 500) and based on 12-month forward-looking forecasts, markets are expecting another +24%, driven by the company tax reform and strong economic growth. Sales grew +9%, reflecting strong final demand. In Europe, Stoxx 600 index companies reported earnings growth of +5% in Q1, and earnings growth of +12% is forecast for the 12 upcoming months. The recent depreciation of the euro somewhat supports export companies in the euro zone, but the political situation is already sensitive in Italy and Spain at the same time as the ECB is preparing for the first measures to tighten its monetary policy. Earnings growth of +15% is currently forecast for emerging markets for this year, with rising raw material prices supporting raw material exporters. Emerging markets have, however, been burdened by rising interest rates in countries with high debt and deficit levels and by the appreciation of the dollar, as well as by country-specific problems related to corruption and misconduct. The tangle of problems is thus a very usual one despite solid growth in EM countries.

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

Market returns 31.5.2018

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

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	1,6 %	10,9 %	10,3 %
Euro Stoxx 50	-2,5 %	-0,8 %	-1,5 %
Stoxx 600	0,1 %	0,3 %	1,0 %
S&P 500	2,4 %	2,0 %	14,4 %
Dow Jones	1,4 %	-0,2 %	18,9 %
Nasdaq	5,5 %	8,3 %	21,3 %
Nikkei (Japan)	-1,2 %	-1,7 %	15,2 %
Hang Seng (China)	-0,4 %	3,0 %	23,5 %
India	0,7 %	4,2 %	15,1 %
Russia (RTS)	1,0 %	1,0 %	15,6 %
Brazil	-10,9 %	0,5 %	22,4 %
MSCI Europe	0,1 %	0,2 %	1,0 %
MSCI World All Country	0,9 %	0,8 %	11,0 %
MSCI Emerging Markets	-2,2 %	-0,4 %	15,1 %
MSCI Latin America	-8,9 %	-1,2 %	13,6 %
MSCI Eastern Europe	-1,8 %	2,6 %	18,9 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	1,4 %	8,9 %	25,8 %
Oil (spot)	-2,1 %	10,9 %	36,6 %
Gold (spot)	-1,6 %	-0,7 %	0,7 %
HFRX Global HF	0,0 %	-2,0 %	0,0 %

Foreign exchange	31.5.2018	30.4.2018
EURUSD	1,17	1,21
EURJPY	127,23	132,05
USDJPY	108,82	109,34
EURGBP	0,88	0,88
EURSEK	10,31	10,57
EURNOK	9,56	9,68
Interest rates		
Fed	1,75	1,75
ECB	0,00	0,00
BoJ	-0,10	-0,10
BoE	0,50	0,50
Euribor 3m	-0,32	-0,33
Euribor 12m	-0,18	-0,19
Germany10y	0,34	0,56
iTraxx Europe 5y (IG)	69,05	54,41
iTraxx Crossover 5y (HY)	305,46	271,07

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

Fixed Income

Past Situation

Italy's interest rates spiked

The rapid rise of Italy's government bond rates (and decline in prices) was a clear change in the fixed income markets compared to the situation earlier in the year. As the elected parties failed to form a government, major traditional political issues, such as leaving the euro zone, were again high on the agenda. Eventually, Italy managed to put together a government, but government bond yield levels were clearly higher than in early May.

The ECB's Target2 payment system is a good barometer of the euro system's internal pressure. The Target2 system shows national euro central banks' receivables and liabilities to the ECB. The increase in Italy's "deficit" indicates a bank run in Italy, which accelerated further at the turn of May-June during the government crisis. Economic players and investors are apparently taking seriously the hints at referendums about staying in the euro. The euro crisis in 2011–2012 caused irreversible damage to GDP growth and corporate earnings growth in the euro zone, and this should be fresh in people's minds. About six years have elapsed since the euro crisis, and the Bundesbank's "receivables" in the Target2 system have done nothing but grow. They are currently at about EUR 1,000 billion, so it is with good reason that the ECB's president Mario Draghi has announced that a country leaving the euro will have to settle its Target2 balance in full.

At the moment, Europe's revived economic growth could very well do without a single populistic comment about better times without the euro or about failing to pay government debt. There is reason to believe that this kind of play will always be staged in Italy in the lead-up to parliamentary elections, as the country's productivity development is falling behind Northern Europe for good.

Current Situation

Companies active on the Nordic issue front

June is becoming one of the most active months of June ever seen on the Nordic corporate bond markets. At this rate, it appears that new corporate bonds worth more than EUR 25 billion will be issued in the Nordic countries. In the US, on the other hand, the issue rate for bonds with a credit rating of BBB- or higher is around 10% lower compared to last year. The backdrop for this is the interest rate rise in the US. In Europe, however, companies' financing departments have been busy before the holiday season. Every company that is able to do so wants to fix their financing costs in a still low interest rate environment, and even more so with credit risk premiums at a relatively low level.

The turbulence experienced at the end of May on Italy's government bond markets and soon after on the country's corporate bond markets has already somewhat widened riskier corporate bond yield levels. On the bank loan markets, the first issue withdrawal was seen in the beginning of June, as Matterhorn Telecom was not happy with the yield expected by investors and withdrew the issue. Dometic also withdrew its plans to issue a high yield bond. More of this can be expected as price volatility in risky asset classes rises from its current levels. The European new issue market froze during Italy's government crisis in early June, reflecting the markets' sensitivity to external shocks at this stage of the economic cycle.

We will continue our selective approach in the new issue markets. In our fixed income portfolio, we have recently participated in the new issues of Norwegian Marine Harvest's and Finnish YIT's corporate bonds and in one new issue in the European bank loan sector. In our view, investors must be very careful about the yield level they are ready to invest at in this phase of the economic cycle, with credit risk premiums also widening to some extent.

The future

Central banks reducing stimulus measures

Central banks' measures to unwind stimulus are progressing in Europe as well. As expected, the ECB announced that it would reduce its balance sheet purchases to EUR 15 billion after October until the end of the year. In the US, the Fed will continue its interest rate hike cycle with three more hikes scheduled for this year and three for next year. This means the key interest rate will eventually climb to more than 3% by the end of next year. With the US 10-year government bond rate at around 3%, concerns are growing about the yield curve (difference between short-term and long-term interest rates) flattening or even becoming inverted (short-term rates higher than long-term rates). Previously, the yield curve has been one of the most accurate long-term economic indicators to predict a downturn.

Reduced dollar liquidity in the markets as a result of the interest rate hikes and the reduction of the Fed's balance sheet (sales of government bonds from the balance sheet) has already made its mark on the financial position of EM countries, for example. Argentina was forced to ask the IMF for an extended credit line and Turkey's central bank has been forced to support the country's currency through emergency interest rate hikes. The situation in Brazil is also deteriorating due to the rapid fall of the country's currency. In addition to the countries' internal problems, all this can be traced back to a tightening financial environment, the rise of US government bonds and interest rates and reduced dollar liquidity – in a way a very classic move. Argentina and Turkey have massive deficits, and with this in mind, the currency correction (–20%) was just a matter of time. We have not been much involved in EMD investments in our ML Fixed Income Portfolio, and the situation still holds little appeal.

Interest rates have been slow to rise in the euro zone, but the winding down of the ECB's stimulus programme in early autumn will start an episode in which credit risk premiums and interest rates in net terms will rise towards year end.

We do not currently hold any euro zone government bonds in our fixed income portfolio.

Equities

Past situation

Equities on the rise again

Increased stock price volatility has been one of the clearest changes compared to last year's market environment. In the aftermath of the early-year volatility, stocks rose markedly in the US in May, with a good earnings season again driving earnings forecast upgrades.

In Europe, Italy's government crisis weakened stock exchange returns in Southern Europe, with Italy in the lead. Italy's banking sector has a lot of Italian government bonds, whose rising interest rates have a negative impact on the marked-to-market performance. In smaller banks, this is an even bigger problem. The banking sector is under pressure also in other parts of Europe, due to a low interest rate level and declining fee income. Deutsche Bank's share has fallen again close to the bottom level of the financial crisis, so they are not out of the woods either. US financial names are in a better position, with the Fed raising the interest rate level and the economy running on all cylinders. The widening of the trans-Atlantic interest rate differential also explains the yield differences of financial sector shares between the US and Europe.

The Helsinki stock exchange main index has experienced excellent growth in relative terms (+10.9% at the end of May) this year, compared to many major indices worldwide in local currencies. A turn for the better in the Finnish economy and thus the recovery of demand in the domestic market is a fact, but the Helsinki stock exchange rise is riding on a few companies. The positive circle has been fuelled by Nokia's, forest companies', Neste's and Fortum's rises.

However, EM stock exchanges have shown a decline, driven by Brazil. The Petrobas corruption scandal is undermining confidence in Brazil's situation, with the country's currency practically in free fall. In China, Hong Kong's Hang Seng index also fell in May. Despite solid GDP growth, rising interest rates in the US and the appreciation of the dollar are a challenging combination for many EM countries that are dependent on foreign financing.

Current situation

Forecasts upgraded after a strong earnings season

The first-quarter earnings season ended with staggering figures in the US. Earnings of S&P 500 index companies rose +25% year on year with sales growth at +9%. At the same time, the economy is gradually becoming overheated, and the Fed is tightening its monetary policy accordingly. Coupled with positive economic development, the corporate tax reform is contributing to earnings development. As a result, markets' earnings forecasts have been upgraded further: currently around +24% for the next 12-month period. It is a high level that will keep the bar high going forward. There will be little room for disappointment when Q2 earnings reporting starts in the summer.

In Europe, Stoxx 600 index companies reported earnings growth of +5% in Q1, and earnings growth of +12% is forecast for the 12 upcoming months (+8% for 2018). Despite the Italian government crisis and stock price decline, the markets are astoundingly positive about MIB40 index earnings growth, which is predicted to be approximately +25% for this year. In terms of sectors, the best results compared to one year ago are shown by oil and gas companies and basic industry companies. The best earnings forecast upgrades also concern energy companies in a global comparison, so the cycle appears to strengthen further in this segment.

The possible escalation of the trade war between the US and its trade partners will quickly stir things up. Threatening with import duties is not productive from the perspective of the global growth environment and can have major impacts on individual companies. So far, little of importance has been seen.

A rise in the interest rate level in Europe, on the other hand, would rapidly raise the earnings and earnings expectations of the banking and financial sector. The unwinding of the ECB stimulus programme in summer is keeping expectations of a gradual rise in interest rates alive.

The future

Equities remain relatively attractive

Following the stock price rise seen in spring and summer and a very good Q1 earnings season, the S&P 500 index has been valued at approximately 16.7x in terms of the forward-looking 12-month earnings forecasts. In the light of this indicator, US equity markets are not overly cheap, but not utterly expensive either on the main index level. Some companies in the technology sector have really challenging valuation factors.

In Europe, the corresponding valuation level of 14.1x for the Stoxx 600 index, examined in light of the 12-month earnings forecasts, is more affordable than the US markets, in keeping with the traditional pattern. This relative valuation difference cannot be expected to turn around any time soon. Dividend yield levels in Europe continue to clearly exceed the low-risk interest rate level, but in the US, dividend yields (before the buyback and cancellation of treasury shares by companies) are already at the same level as the interest income from short-term government bonds. However, treasury share buybacks as a whole and brisk M&A activity, coupled with positive earnings development, still continue to support the equity markets.

At the start of summer, it appears that 2018 is becoming the most active M&A year ever in terms of both numbers and volumes in the US and Europe alike. Cheap debt is fuelling M&As. The S&P 500 index's "net debt per EBITDA" is currently around 1.2x, but it is not exceptional that following an M&A, with additional leverage from the new owner, the company's indebtedness is as high as 7x with the same indicator. As a whole, with the economic cycle advancing and earnings growth looking good, we believe that equities still offer relatively better conditions for a rise in value than low-risk fixed income instruments. Having said this, we do consider it worthwhile to do some rebalancing, i.e. bring the equity weight that has increased due to the equities themselves back to the initial situation.

Alternative investments

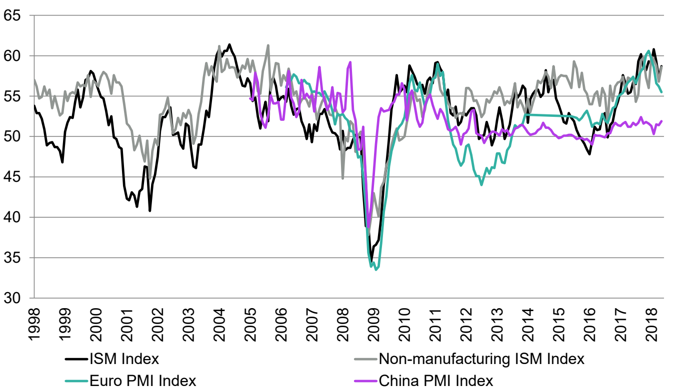
With regards to alternative investments, no significant developments are at hand. The low level of risk-free interest rates particularly in the euro zone is still pushing investors towards asset classes with no daily redemption opportunities. This is how investors are looking for higher yields resulting 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 or slightly above it. 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. In our view, as a whole, the market situation is still quite favourable for private debt investments, from the perspective of long-term investors, particularly compared with traditional asset classes.

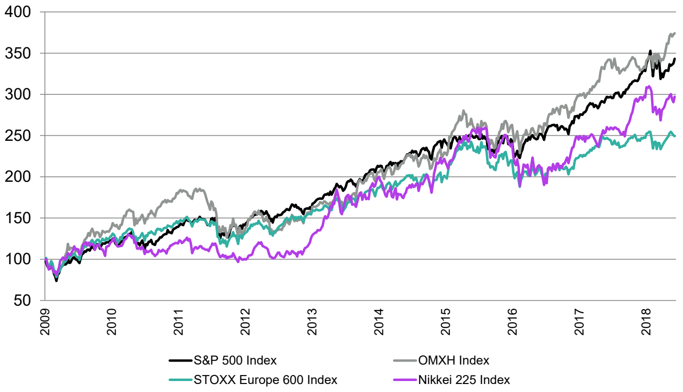
On the private equity markets, valuation levels are at an all-time high. The performance of private equity funds last started up at these valuation levels between 2006 and 2007 remained modest once the financial crisis hit the markets in 2008. At the moment, the volume of investment capacity in private equity funds is at an all-time record level and we have made new investments extremely selectively. Investments have only been made in those parts of the markets in which we see less competition. Instead of traditional buyout investments, we have made investments in Nordic growth funds, or if we consider 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

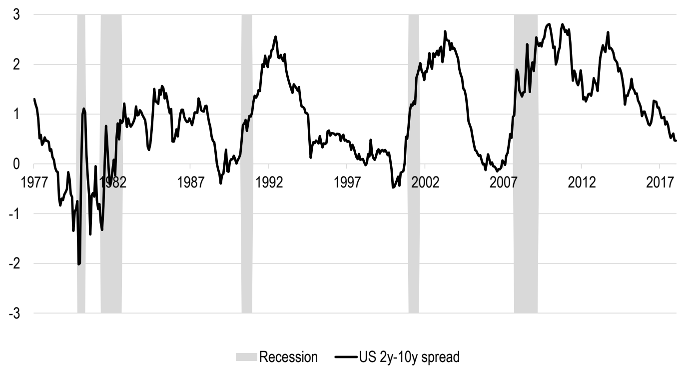


Equity index development (2 Jan 2009 = 100)



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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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