MANDATUM LIFE

Market Outlook

4 May 2017

European outlook stabilising – investment flows to equities continue

Stocks continued to climb in April following a strong first quarter. European equities were doing particularly well, supported by a good earnings season and lower political risk. The first round of the French presidential election was uneventful and credit risk premiums shrank clearly throughout the asset classes.

Companies are currently reporting their Q1 earnings. Earnings have proven to be a positive surprise in the US, Europe and the Nordic countries alike. In Europe, the equity markets have risen clearly and, thanks to the strengthening of the euro, the European equity markets have finally yielded better than the US main markets as of the beginning of the year. Investments continue to flow towards equities and fundamentals in Europe also favour the positive approach on the markets. We are maintaining our neutral recommendation for the equity markets. We will also maintain European companies in moderate overweight and our moderate underweight recommendation for US equities. Similarly, the share of fixed income investments will remain at neutral weight.

Allocation

- **Fixed income**: We will maintain fixed income at neutral weight.
- **Equities**: We will maintain equities at neutral weight.
- **Alternative investments**: We will maintain alternative investments at moderate overweight.

Interest rates continue to fluctuate in Europe driven by the political risk premium and, on the other hand, strengthened economic development and thus higher inflation expectations. The interest rate on Germany's 10-year government bond has fluctuated between 0.17% and 0.45%. According to our insight, interest rates have passed rock-bottom in the euro zone. The ECB has not yet been willing to give the markets leave to factor interest rate hikes into forecasts and has communicated very little on the timing of the winding down of the QE programme. We predict, however, that with positive economic development and rising inflation, the ECB will announce late in the year the schedule according to which it will begin to reduce its purchases of secondary market bonds.

Currently, there is strong demand for corporate bonds and credit risk premiums have tightened to this cycle's lowest figures. Companies are refinancing their bank loans at a tightening pace and there is reason to be careful also on the corporate bond markets. Even the European derivative instrument (iTraxx X-over) that invests in the riskier high yield credit risk market only yields 2.4%. This is not much but with the interest rate floors in negative territory, money is flowing at an increasing rate into corporate bonds.

The early-year rise in the equity markets continued in April. The earnings season has been strong in the US where Q1 earnings were, on average, up to 15% above last year's corresponding period. Also in Europe, the earnings of companies on the broad Stoxx 600 index were as much as +23% above last year's Q1, which means that earnings momentum has turned strongly on the old continent. The growth in net sales has also been good but guidance for the future will continue to be cautious across the board.

Macro figures have strengthened but market expectations in the US in particular are at such high levels that real economy figures have not quite managed to reach forecasted levels during the past month. The continuation of the positive element of surprise offered up by economic figures would require decidedly more moderate expectations over upcoming weeks. The advancing of the tax reform in Congress is the next significant milestone in terms of the big picture for US companies. To date, Trump's administration has already backtracked on its tax reform plans during the election. How much faith could be placed in future GDP development and future tax income in terms of US debt sustainability if taxes were to be reduced in virtually all income categories? The markets have not forgotten the debt-ceiling crisis of 2011 when Congress was unable to agree on the raising of the maximum debt amount laid down by law.

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Market returns 28.4.2017

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

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	5,1 %	9,7 %	27,9 %
Euro Stoxx 50	2,0 %	8,9 %	20,9 %
Stoxx 600	2,0 %	8,2 %	16,6 %
S&P 500	1,0 %	7,2 %	17,9 %
Dow Jones	1,4 %	6,7 %	20,9 %
Nasdaq	2,3 %	12,7 %	28,2 %
Nikkei (Japan)	1,5 %	1,2 %	17,4 %
Hang Seng (China)	2,1 %	12,5 %	21,4 %
India	1,0 %	12,6 %	18,4 %
Russia (RTS)	0,1 %	-3,2 %	22,4 %
Brazil	0,6 %	8,6 %	21,3 %
MSCI Europe	1,7 %	7,7 %	16,7 %
MSCI World All Country	1,3 %	7,0 %	17,6 %
MSCI Emerging Markets	2,3 %	10,3 %	17,8 %
MSCI Latin America	0,8 %	8,5 %	15,6 %
MSCI Eastern Europe	2,8 %	-3,0 %	11,3 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	-2,1 %	-7,1 %	-3,6 %
Oil (spot)	-3,4 %	-9,8 %	0,8 %
Gold (spot)	1,4 %	9,9 %	-2,6 %
HFRX Global HF	0,3 %	1,4 %	4,2 %

Foreign exchange	28.4.2017	31.3.2017
EURUSD	1,09	1,07
EURJPY	121,53	118,67
USDJPY	111,49	111,39
EURGBP	0,84	0,85
EURSEK	9,65	9,56
EURNOK	9,35	9,17
Interest rates		
Fed	1,00	1,00
ECB	0,00	0,00
BoJ	-0,10	-0,10
BoE	0,25	0,25
Euribor 3m	-0,33	-0,33
Euribor 12m	-0,12	-0,11
Germany10y	0,32	0,33
iTraxx Europe 5y (IG)	66,53	74,04
iTraxx Crossover 5y (HY)	266,10	290,28

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

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Fixed income

Past Situation

Interest rates bottom out in the euro zone

On Europe's low risk government bond market the interest rate level has moved horizontally with Germany's 10-year bond leading the way within the variation range +0.17% and +0.45%. The rise in political credit risk premiums before the French presidential election's first round increased demand for German bonds. The brightening of the economic outlook and slight rise in inflation expectations at the turn of April and May caused the interest rate level to rise somewhat. The ECB reduced its balance sheet stimulus purchases coming into April to EUR 60 billion a month and will continue with its purchases until the end of the year. In its latest comments, ECB members have repeated that they are in no hurry to adjust the key interest rate (deposit facility rate for commercial banks still -0.4%) in the near future. An overly expansive monetary policy that is noticeably detached from real GDP and inflation development is, however, a clear risk, which market operators and the ECB are well aware of. Now, during the ultra-low interest rate level and targeted longer term refinancing operations (TLTRO), would be the perfect time for the Southern European banking sector to fix the situation and write off distressed debt while the ECB's "indirect bank support" is still ongoing.

In April, the inflation rate in the euro zone was +1.9% according to preliminary figures and, less food and energy, underlying inflation was +1.2%. The growth in the money supply (M3 money) is at +5.3% annually, which means that lending is also experiencing good growth in the euro zone. The national economies of different member countries are thus recovering and this year's GDP growth forecast of +1.6% in the euro zone seems to be well within reach.

Current Situation

High demand for corporate bonds

Companies have accelerated their use of the low interest rate and credit risk premium levels in their financing. In the bank loan markets, European companies are refinancing their loan packages at a fast rate and many high yield companies have already been able to lock down credit risks at below 3%. In European bonds, EUR 200 billion in investment grade bonds with higher credit ratings have been issued up to the end of April, with the corresponding figure in the United States at USD 470 billion. In Europe, things are moving somewhat slower than last year, but in the US, clearly above the previous year's corresponding period. In the US high yield markets, the quality of credit risk on the index level is weaker (net debt per EBDIT approx. 5x) than at the tightest credit risk premium levels in the previous cycle (corresponding ratio 4x in 2007). One reason for this is the still relatively large share of the index taken up by energy companies.

Globally default rates have started to fall as the economic cycle improves practically in all the major economic zones. According to Moody's statistics, the 12-month backward-looking default rates of high yield companies are at 3.8%, compared to +4.8% at the end of last year. Default rates have fallen especially in the US. The rearrangements of the balance sheets of the most risky companies on the Nordic corporate bond markets are mostly over and credit risk premiums have shrunk considerably. Our ML Nordic High Yield investment basket has, as a result, yielded more than 7% at a very low interest rate risk (*interest rate duration* 0.6 years). The total forward-looking return level of the portfolio's investments is still at around 6%, which means a good outlook for the remainder of the year. We are maintaining our moderate overweight recommendation for corporate bonds coming into May.

The Future

When will the Fed begin reducing its balance sheet?

Demand for bonds is altogether strong in the markets but major changes may be on the horizon in terms of the central banks. In the US, the reducing of the Fed's balance sheet is a hot topic of discussion at the moment and, according to estimates, the Fed's balance sheet will be USD 200 billion smaller next year. In practice, this means that buyers need to be found elsewhere for US government bonds. Reducing the balance sheet is simultaneously a relatively significant monetary policy tightening measure. Currency reserve investors in the Emerging Markets area, China and Japan and oil exporters have traditionally been major buyers but the slowing down of the accumulation of these currency reserves is bringing uncertainty to the demand for US bonds. In terms of additional investments, the focus is on US investors, households and institutions. If purchases fail to start accelerating, the price of bonds will come down (and interest rates up) until government bonds once again interest investors. The US 10-year bond is currently at 2.28%. A larger supply is in store once Trump's infrastructure investments move forward and the administration is planning for ultra-long government bonds of 50 and 100 years for the US. The credit risk premiums on longer-term US government bonds are still not very attractive with one or two interest rate hikes by the Fed factored into prices for this year. At this rate, the difference between long- and short-term interest rates is likely to narrow in the US.

GDP development (just +0.7% in Q1) has failed to meet expectations in the US with consumer demand remaining below forecasts. Companies' producer prices are currently rising by +2.3 per cent and consumer prices by +2.4 per cent annually. Significant further acceleration of inflation is not currently being factored in in the US but after a soft Q1 it is a possibility. All in all, there is reason to be selective and keep some cash in portfolios while waiting for better fixed income market levels in order to invest.

Equities

Past Situation

European equities rose well from the beginning of the year

Following a positive first quarter, European stocks continued to rise when the first round of the French presidential election did not provide any major surprises at the end of April. Political risk took a back seat in the markets and price volatility fell. French equities and France-related credit risk premiums in general fell on the markets. This year in Europe, the Stoxx 600 index rose by +8.2% at the end of April and in Helsinki the main index rose by as much as +9.7%. In the US, the S&P 500 index rose by +7.2% at the end of April. When taking into account the 3-per-cent weakening of the dollar from the perspective of the euro investor, it is possible to say that European equities have at long last performed clearly better than their US counterparts. Within equity markets, we are maintaining our moderate overweight recommendation for European equities and similarly maintaining US equities in moderate underweight.

In the US, the development of the Q1 GDP (+0.7%) remained well below the expected level with softer-than-expected consumer demand figures, among other things. Generally speaking, precisely the United States' real economy statistics have failed to reach market expectations and, against this background, the positive element of surprise is dwindling. Equity markets in the US have been trending upward, however, which is why the difference compared to the recent development of the real economy is becoming considerable. PMI levels are still good in the US (Markit's total PMI at 52.0).

In Europe, cyclical sectors (financial services and basic industry) were among the top performing sectors in April with, for instance, political risk taking a back seat. More defensive sectors, on the other hand, experienced more moderate development in April.

Current Situation

Successful Q1 earnings season

In the US, companies' corporate earnings have been surprisingly positive. For the first quarter the earnings growth for S&P 500 companies that have already issued reports has been +15% compared to a year earlier (more than 80% of companies exceeded market expectations), moving at its best pace since 2011. Growth in sales has also been strong; currently, net sales growth is clearly above 5%. Compared to a year earlier, in addition to a robustly performing energy sector, the figures of other sectors are also encouraging.

In Europe, the earnings season has been even stronger. So far, Stoxx 600 index companies have reported an improvement in earnings of as much as +23% compared to the corresponding period last year. This applies to a broad range of sectors, so there is more to it than just an improvement in the situation for energy companies.

In the Nordic countries the earnings season has also been a bigger success than expected. With two-thirds of companies having reported their earnings, 70% of companies have exceeded expectations with earnings growth as high as +13%. Following the good earnings season, the market is interested in whether forecasts are still on their way up or not. So far, earnings forecasts for the rest of the year have been adjusted carefully and, for the S&P 500 index, the markets are predicting +10% earnings growth. In Europe, the Stoxx 600 index's earnings growth forecast for 2017 is still a crisp +14.5%. We expect earnings expectations to calm down on the markets during the remainder of the year. An improvement of up to +40% in earnings is predicted for the Italian MIB 40 companies, which means that the recovery of the banking sector is already being factored into prices. Also the earnings of the automotive and basic industry sectors are predicted to recover clearly from last year in Europe. Overall, sales growth expectations in Europe are +6.9% on the Stoxx 600 index for this year, the obvious turnaround of the economy is factored into forecasts. Barring any major political turbulence, this is a possibility.

The Future

We will maintain our neutral recommendation for equities

Issues related to the United States' upcoming tax reform are on the agenda in the stock markets. The latest news on the topic was so meagre that equities were unaffected in the US. In terms of tax reform, Trump has pulled back considerably from the level he indicated in his campaign speeches, which, together with the difficulty of pushing through the health care reform, indicates that achieving a balance in Congress will be challenging. How much will Trump's administration rely on positive GDP development and thus on later, more comprehensive tax income in terms of US debt sustainability when income tax is reduced in practically all income categories? The markets have not forgotten the debt-ceiling crisis of 2011 when Congress was unable to agree on the raising of the maximum debt amount laid down by law. For companies, what is significant is of course the level of the corporate tax rate (15%?) but also any tax relief given for repatriating profits from abroad to the US. Similarly new duties or additional taxes to be paid at the US border will impact the outlook for many foreign companies as well.

In Europe, the first round of Brexit negotiations have begun in an intense mood. Differences in views on costs (approx. EUR 100 billion) are far apart enough that it will be a very difficult two-year negotiation period. Prime Minister May is seeking broader support and a mandate for the negotiations in June's parliamentary elections, but in terms of the markets and the rest of the year the movements of the pound, British stocks and the UK's interest rate level will be more volatile this year.

We will maintain our neutral recommendation for the equity markets and, within equities, the moderate underweight for the US markets and moderate overweight for Europe. Europe's outlook in particular is clearly brighter for companies and real economies.

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Alternative Investments

Our allocation recommendation for alternative investments remains at moderate overweight. The basic situation remains unchanged: the interest rate level is very low, which, in the big picture, steers allocation assets to illiquid investments, in which this so-called illiquidity premium (additional yield requirement) is sought out as part of the yield.

We are maintaining our recommendation for private debt at moderate overweight. The amount of cash in European private debt funds appears to be even smaller than around the same time a year ago. The situation has not changed significantly in the investments we have selected or in their target market. Investments made at the end of last year seem to be very similar to earlier ones in light of yield levels and key figures, although the situation in the bond and bank loan markets has become more favourable for debtors.

In the convertibles markets, development followed general risk appetite in accordance with the convertibles market profile. The earnings season in Europe has been a success, which also helps support the convertibles markets. The price of optionality linked to convertibles is relatively cheap at this moment and the sensitivity of our investment basket to the underlying European equity market is some 38%. Convertible bonds currently offer a good risk-adjusted asset class between low interest rates and increased stock market valuations.

Yield requirements in the real estate markets in the best city-centre properties and properties with long-term lease agreements are at a very low level. Differences in yield requirements between prime investments and riskier investments are still attractive in places especially from the perspective of real estate development additional yield element. We are currently focussing particularly on these types of value add investments in our real estate investments. Similarly the real estate market is still very attractive and achieving 8–10% yields is still possible.

Market outlook (change to previous month)		Monthly recommendations 1/2015 - 5/2017*																												
		1	2	3	4	5	6	7	8	9	10	11	12	1	2	3	4	5	6	7	8	9	10	11	12	1	2	3	4	5
Fixed Income: Neutral	**(=)**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**2**	**2**	**3**	**3**	**3**	**3**
Europe money markets: Neutral	(=)	1	1	1	1	1	1	1	1	1	1	1	1	1	1	2	2	2	2	2	2	2	2	2	2	2	2	2	3	3
Europe government bonds: Underweight	(=)	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Investment grade: Moderate overweight	(=)	2	2	2	2	2	2	2	2	2	2	3	3	3	3	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
High yield and structured products: Moderate overweight	(=)	4	4	4	4	4	5	5	5	5	5	5	5	5	5	4	4	4	4	5	5	5	5	5	5	5	4	4	4	4
Senior loans: Moderate overweight	(=)																								5	5	4	4	4	4
Emerging market bonds: Underweight	(=)	3	3	3	3	3	3	3	2	2	1	1	1	1	1	2	2	2	2	1	1	1	1	1	1	1	1	1	1	1
Inflation: Moderate underweight	(=)	1	1	1	1	1	1	1	1	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Equities: Neutral	**(=)**	**4**	**4**	**4**	**4**	**4**	**4**	**4**	**4**	**4**	**4**	**4**	**4**	**4**	**4**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**4**	**4**	**3**	**3**	**3**	**3**
USA: Moderate underweight	(=)	3	3	3	2	2	2	2	2	2	2	2	2	2	2	3	3	3	3	3	3	3	3	3	3	3	3	3	2	2
Europe: Moderate overweight	(=)	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
Finland: Neutral	(=)	2	2	2	2	2	3	3	3	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	3	3	3	3
Scandinavia: Moderate overweight	(=)	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	4	4	4	4
Japan: Underweight	(=)	2	2	2	3	3	3	3	3	3	3	3	3	3	4	4	3	3	3	3	2	2	1	1	1	1	1	1	1	1
Emerging markets: Neutral	(=)	3	3	3	3	3	3	3	3	2	2	2	2	2	2	2	2	2	2	2	3	3	3	3	3	3	3	3	3	3
Alternative Investments: Moderate overweight	**(=)**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**4**	**4**
Private equity: Moderate underweight	(=)	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Private debt: Moderate overweight	(=)																								4	4	4	4	4	4
Real estate: Moderate overweight	(=)	3	3	3	3	3	3	3	3	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
Convertible bonds: Moderate overweight	(=)	5	5	5	5	5	5	5	5	5	5	5	5	5	5	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
Commodities: Neutral	(=)	2	2	2	2	2	2	2	2	2	2	2	2	2	2	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3

* Explanations: 1 = Underweight, 2 = Moderate underweight, 3 = Neutral, 4= Moderate overweight, 5 = Overweight

The weights describe our recommendation in relation to each investor's investment plan's balanced situation.

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