MANDATUM LIFE

Market Outlook

7 July 2017

Central banks already talking about reducing stimulus in Europe

Equity markets declined in June to close a successful early year. The upward momentum calmed down after the interest rate level took a slight upward turn, as expected, once the European Central Bank and the Bank of England cautiously started to communicate that the first steps of winding down stimulus would be ahead.

The rise in interest rates in Europe clearly strengthened the euro, further widening the equity market return differential across the Atlantic without currency hedging. At the end of June, the return on the S&P 500 index for the euro investor (without dollar hedging) since the beginning of the year was only +1.0% (+9.3% in USD), while the broad Stoxx 600 equity index in Europe has yielded +7.0%. European economies are recovering at a solid pace (growth forecast for this year +1.8%) and even the Finnish economy has taken an upward turn. Global economic growth continues to be on a good level, with a GDP growth rate of +3.4% forecast for this year. We have not made any significant changes in our allocation. Equity weight is practically neutral.

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 rose clearly at the end of June in the euro zone. In its recent comments, the ECB led on that the current type of stimulus might need to be reduced in future, and this came as no surprise to us. The ECB will end the purchases under its current quantitative easing programme at the end of this year, and by then, it is most likely to announce a reduction of its bond purchases. The most powerful stimulus period will soon be behind us, and, as we see it, the interest rates have already bottomed out.

At the end of June, the interest rate of Germany's 10-year Bund rose to +0.45%, which is still a very low level, while the 5-year Bund is still in negative territory. There is thus room for the interest rates to rise, once economic development and the inflation picture improve further.

Globally speaking, inflation is not a threat at the moment. The US has practically full employment, and wage pressure is starting to emerge, prompting the Fed to raise the interest rate at least once more during the rest of the year. In Europe, inflation is still clearly below the ECB's 2% target, and with the current raw material price development, no dramatic change is expected in terms of inflation during the next few months. However, interest rates are already reacting to the ECB's statements – even surprisingly sharply.

Price volatility in the stock markets has continued to be quite low. In June, the stock market rally calmed down as the stock prices of technology companies, which experienced a strong rise in the early part of the year, especially in the US, fell slightly.

The markets are heading into the Q2 earnings season beginning in July in an expectant mood. On a global level, real economy statistics have no longer been as positive a surprise compared to market expectations as they were in the spring, although companies' PMIs still indicate a good level of production in the private sector. There have also been very few profit warnings in the lead-up to the Q2 earnings season, so it would be surprising to see earnings and especially the subsequent comments fail market expectations.

Currently, earnings growth of +10.4% and up to +19% is forecast this year for the S&P 500 index and the European Stoxx 600 index, respectively. A lot of positive expectations have been put especially on European companies, and in the stock markets also, non-European investors have continued to buy European stocks. Political risk has receded to the background in Europe, and the growth outlook is good. The German parliamentary election in the autumn will not rock the boat.

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Market returns 30.6.2017

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

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	-0,7 %	11,4 %	27,5 %
Euro Stoxx 50	-3,0 %	6,7 %	23,3 %
Stoxx 600	-2,5 %	7,0 %	18,2 %
S&P 500	0,6 %	9,3 %	17,9 %
Dow Jones	1,7 %	9,3 %	22,1 %
Nasdaq	-0,9 %	14,7 %	28,3 %
Nikkei (Japan)	2,1 %	5,8 %	31,1 %
Hang Seng (China)	1,4 %	19,5 %	27,8 %
India	-0,3 %	17,0 %	16,0 %
Russia (RTS)	-3,9 %	-11,9 %	13,5 %
Brazil	0,3 %	4,4 %	22,1 %
MSCI Europe	-2,5 %	6,7 %	18,0 %
MSCI World All Country	0,2 %	9,0 %	19,2 %
MSCI Emerging Markets	1,6 %	14,8 %	21,8 %
MSCI Latin America	0,9 %	7,2 %	16,7 %
MSCI Eastern Europe	0,1 %	-7,7 %	11,4 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	-1,9 %	-10,2 %	-9,0 %
Oil (spot)	-5,2 %	-15,8 %	-12,2 %
Gold (spot)	-2,6 %	7,6 %	-7,1 %
HFRX Global HF	0,1 %	1,6 %	3,9 %

Foreign exchange	30.6.2017	31.5.2017
EURUSD	1,14	1,12
EURJPY	128,40	124,56
USDJPY	112,39	110,78
EURGBP	0,88	0,87
EURSEK	9,63	9,77
EURNOK	9,54	9,48
Interest rates		
Fed	1,25	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	-0,16	-0,13
Germany10y	0,47	0,30
iTraxx Europe 5y (IG)	56,08	62,27
iTraxx Crossover 5y (HY)	246,67	252,47

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

Fixed income

Past Situation

Interest rates bottom out in the euro zone

Interest rates took an upward turn in Europe in June, as the markets interpreted the comments of the ECB's President slightly more hawkishly than was warranted. The interest rate on the German 10-year Bund rose to +0.45%, because, according to Mario Draghi, the amount of the current type of stimulus will have to be assessed in the future, and the downside economic risks have diminished. Simultaneously, statistics show that towards the end of June, the ECB actually markedly reduced its purchases of government bonds in the short term within its QE programme, which gave interest rates room to rise in the markets. According to the ECB's statistics, it has fallen a bit short of the purchase amounts according to its capital key, with the amount of German government bonds failing to meet the target and that of the Southern euro zone government bonds exceeding the target.

In our view, the euro zone interest rates have bottomed out and there is room for interest rates to rise going forward. Radical changes in the interest rate level will not necessarily be seen in the immediate future, but the ECB's QE purchase amounts will be downsized during next year, which means that one large buyer will be exiting the euro zone government bond and corporate bond markets in the longer term.

The markets currently do not expect the first key interest rate hike by the ECB to take place until next year's final quarter, indicating that, so far, the markets have embraced the ECB's new tone quite calmly. This can partly be explained by the continued low inflation – according to estimates, the inflation rate in the euro zone in June was only +1.3%.

Current Situation

Abundant supply in corporate bond markets

An abundant supply was seen in the European corporate bond markets in June, as a total of EUR 41 billion worth of new corporate bonds were issued. Since the beginning of the year, new bonds have been issued in the amount of EUR 188 billion, which means that the pace is higher than last year. In the Nordic countries, corporate bonds have also been issued at a vigorous pace.

We have been quite selective about new issues. In Finland, too, many companies seized the opportunity to lock low credit risk premium and underlying interest rate levels as their financing costs. With an extremely high level of demand on the issue markets on average, it was not surprising to see that in the case of many issues, the original credit risk premium (in other words, the return achieved by the investor) shrunk considerably already at the issue stage as subscription books grew. As a consequence, we chose not to participate in a number of Finnish non-credit-rated issues as the final return level no longer met our expectations.

In the money markets, interest rates are in the negative and banks are charging fees to customers for having their money sit in current accounts, so investors on average are facing strong pressure to invest their assets in the markets. Still, we think there is reason to be selective in this kind of market environment where credit risk premiums are at a very low level. The credit risk premium for the European higher risk high yield market derivative contract is no more than 2.4%, and in the cash market, the return level for the index investor is only 2.6%. We consider this to be too little, so now is not the time to make any major increases in high yield investments.

Instead, the Nordic high yield market offers better return opportunities, as our ML Nordic High Yield investment basket currently generates returns of around 6.5%, and this with a practically floating coupon flow, making it a very interesting market also in a possible environment of rising interest rates.

The Future

Central banks about to unwind stimulus in Europe

We expect the ECB to announce in the autumn the schedule according to which it will set out to reduce its purchases under its QE programme. It is highly likely that the winding down of the purchase programme will be in full swing before the first key interest rate hike sees the light of day. Simultaneously, we predict that the BoE will give signals about key interest rate hikes and the reduction of its QE programme. Sweden's central bank will most likely be forced to follow the lead of its larger European counterparts in order to keep the foreign exchange market together. In practice, history repeats itself in this respect too, i.e. the US is approximately a year ahead of Europe in central bank monetary policy.

A possible significant rise in long-term interest rates would be accompanied by the acceleration of inflation expectations in all economies, although no major signs of this can be seen at the moment. A kind of Goldilocks environment thus remains and keeps price volatility in check in the fixed income market as well. Should inflation expectations reach unsustainable levels due to rising raw material prices or the overheating of economies and wage pressure, central banks would have to adjust their key interest rates upwards at a faster pace. In a scenario like this, risky asset classes would show a clearly weaker performance.

Wage-push inflation is still very moderate in Europe, but with unemployment rates falling and the basic market sentiment remaining at its current level, it is clear that wage demands will rise somewhat also in Europe. The US practically enjoys full employment, with the wage increase rate at approximately 3%. The Fed will raise its key interest rate once or twice this year, unless the US economy faces an unexpected deceleration due to an external shock.

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Equities

Past Situation

Europe outperforming the US this year

European stocks have continued to outperform US stocks in relative terms this year. The broad Stoxx 600 index has yielded +7.0% from the beginning of the year until the end of June and the S&P 500 index only +1.0% in euros due to the weakening of the dollar (+9.3% in USD). The main currency movements will gain strength, as Europe in particular will be more in the know about the ECB's schedule for less stimulating monetary policy during autumn.

Emerging economies have also been going strong in the early part of the year, with the MSCI EM index rising +14.8% in local currencies. With the Hong Kong Hang Seng index rising as much as +19.5% in the early months of the year, China's debt has not been a major concern. China's Party Congress next autumn will ascertain that no major policies will be outlined in the next few months, which will also cause the stock market rally to calm down.

Sector-wise, biotechnology, healthcare and the banking sector were the biggest climbers in the US in June. Banks and financing institutions were boosted by rising interest rates. Technology companies clearly fell in June, but since the beginning of the year, they have continued to outperform the main index in the US, together with financial services.

In Europe, retail, oil service and telecommunications companies performed the weakest, whereas the insurance, banking and financial sectors benefited from rising interest rates and were the best climbers in relation to the main index.

It is clear that the continued interest rate rise will further boost European banks while the splitting up and reorganisation of the weakest Italian and Spanish banks proceed under the ECB's guidance.

Current Situation

Europe in recovery

The recovery of European equities is in full swing. The Q2 earnings season that will start in July will be important in that it will provide a new reference for earnings growth expectations. The markets are forecasting +19% earnings growth for the Stoxx 600 index for this year and +9% earnings growth for the next.

European economies are experiencing solid growth compared to the past couple of years and European companies' PMIs are on a good level. The most recent total figure from Europe is 56.3, indicating a strong level of production. Profit warnings have also not been given to any great extent in Europe in the lead-up to the earnings season, so the starting point is good. Earnings performance still seems good to us and due to the cost savings and austerity measures carried out in previous years, increased net sales can now be seen more clearly on the bottom line.

Sales growth expectation for the Stoxx 600 index is +7% for this year and close to +4% for next year. In the US, Q2 expectations are also positive, and double-digit quarterly earnings growth is a possibility. For the S&P 500 index, the earnings growth forecast is +10% for this year and +12% for next year. Net sales are expected to improve by +3.7% this year and +4.7% next year.

Companies state that labour markets in the US are tight and wage pressure is felt on a broad scale. To date, profit margins have held their own fairly well in the US. It would be surprising were the earnings season to fail expectations in Europe or in the US. That means that no significant earnings-related changes are in store in equity market valuation factors.

The Future

Stock prices and earnings growth in equilibrium

Companies' current earnings momentum is positive. New statistics will be available in July–August when companies report their Q2 figures. In the big picture, we do not expect them to bring any major changes in stock market valuations. Economic development in both Europe and the US is positive. In the US, real economy statistics no longer are as positive a surprise compared to market expectations as they were in the spring, but as such, this is not surprising.

The Fed's interest rate hikes are proceeding in the US, and the labour market is enjoying practically full employment. Globally, inflation is still in check in all of the major economies, so it cannot be foreseen at the moment that the central banks would have to tighten their monetary policy faster than expected. This plays a role in terms of risky asset classes, which is why we still see the longer-term outlook for the equity market as relatively good.

The interest rate level continues to be low on a broad scale, and the US is practically the only country to have seen a major upward correction in its long-term interest rates at the turn of last year. That means that in Europe, among other areas, risk-free fixed income markets are not a relevant parking space for investors and assets continue to flow to the equity markets. There are investment flows to the European equity market also from abroad now that the political risk in Europe has receded to the background and real economies are recovering at a solid pace.

The ECB's stimulus programme is still wide open, but next year it will be tightened. Before that happens, the banking sector and the economies in Southern Europe must be in a condition that will allow them to withstand a higher interest rate level. Against this backdrop, it is not surprising to see the dismantling and rescue operations of Spanish Banco Populare and Italian Veneto Banca and Banca Popolare di Vicenza initiated by the ECB. Similarly, the state subsidy granted to Banca Monte dei Paschi di Siena (MPS) with higher distressed debt and the distressed debt programme fall into the same category. The arrangements must be completed before the Italian government bond interest rates rise. From the equity markets' perspective, these are positive signals, as solutions are finally being sought for Southern Europe's banking problems.

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Alternative Investments

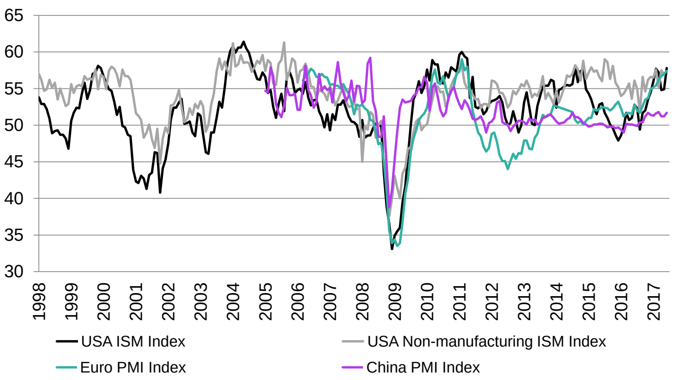
Alternative investments were popular among investors also in June, with the return levels and return expectations on the more traditional asset classes being relatively low.

Cash has been invested in European private debt funds at a good rate, on average. In June, the situation did not change substantially in the investments we have selected or in their target market. Companies are refinancing their loans with a lower interest rate at an accelerating pace, just like in the bond markets.

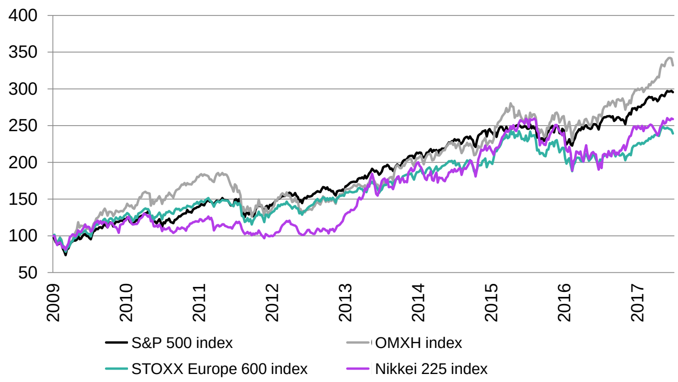
There is thus reason to be selective in the senior loan market, as we think that many refinancing rounds will result in too low a return for the investor. According to the analysis of the research company Preqin, private equity funds contained a massive USD 820 billion in cash globally (USD 755 billion at the end of 2015), so there should be enough ammunition if investment opportunities were to arise. More assets will soon be available, as the 100-billion-dollar Vision fund of Japanese Softbank is starting up its operations. According to estimates, a total of USD 100 billion has been invested in Asian technology startups since the beginning of 2012, which puts Softbank's new fund well into perspective.

The interest rate rise seen at the end of June in the European convertible bond market was reflected especially in the stock prices of real estate companies and their convertible bonds. An abundant supply was seen on the convertibles market in June, as in corporate bond markets, but we did not participate in any new issues in our ML Convertible investment basket. Selectiveness is key in this market too.

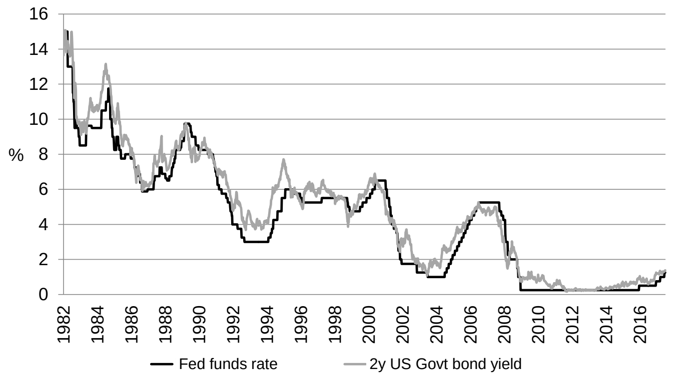
Purchasing managers' indexes



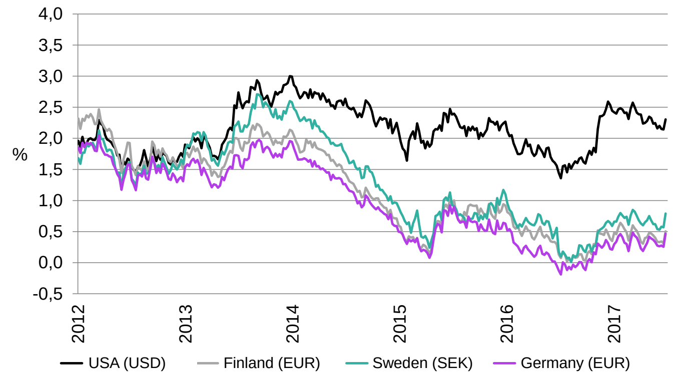
Equity indexes (2.1.2009 = 100)



Fed funds rate and 2y government bond yield



10y government bond yields



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