MANDATUM LIFE

Market Outlook

September 2018

Longest ever bull market rally on record in the US

The equity markets finished in August with the longest bull market rally on record in the US. The bull market rally, which has continued for nine years and five months since the financial crisis, has simultaneously carried the S&P 500 index to an all-time high. The real economy cycle is still a few months away from achieving the same. A strong Q2 earnings season supported the surge in equities and the strength of the US equity markets compared to the rest of the world is now significant, even from a historical perspective. The US economy is firing on all cylinders (GDP growth is approx. +4% at the moment) and inflation is yet to show signs of a major pickup. Read more about the positioning of our allocation products in the current situation in our Allocation Insight.

No major movements occurred in the fixed income markets after the holidays. The ECB will continue to buy EUR 30 billion in bonds for its balance sheet in September but will reduce this to EUR 15 billion per month until the end of the year. The purchases will then end, if the timetable holds. There is still, however, some way to go before the first interest rate hike – we do not expect the ECB to make a move until the autumn of 2019. Inflation is gradually waking in the euro zone and creeping towards the ECB's 2% target. With inflation expectations remaining moderate and pay pressure in control, the ECB is in no hurry to start an interest rate hike cycle.

Norway and Sweden will begin their interest rate hike cycles before the euro zone. Pressure is continuing on the emerging fixed income markets (EM) with dollar liquidity decreasing and a strong dollar keeping investors nervous. As of yet, major redemption flows have not taken place from international EM fixed income funds. The basic scenario on the corporate bond markets is unchanged; credit risk premiums are still low in the big picture and the interest rate risk on the index level is significant in relation to the yield buffer created by credit risk premiums. This is why we currently favour the active management of interest rate risk and investments in short interest rate risk (duration).

We are halfway through September and it is ten years since Lehman Brothers applied for bankruptcy. In honour of this anniversary, equities secured a new record for the longest bull market rally in the US. This year in particular, the US equity markets have clearly beaten the main European indices and EM stock markets. In fact, only India's market and the main Helsinki index were able to challenge the US stock markets in local currencies.

Earnings growth is still very strong in the US. Growth of +23% compared to 2017 is still forecast for this year. In Europe, earnings growth has been more subdued, but with positive expectations in the air, growth of +8% is expected for this year. The earnings expectations of EM companies have been downgraded on the markets, but +15% growth is still forecast for this year. Trade war rhetoric is escalating as we speak, with negotiations between China and the US floundering. It is unlikely in our view, that a quick solution will be found, which leaves a dark cloud hovering over the EM countries for some time to come. The continuation of the Fed's interest rate hikes and the appreciation pressure still affecting the dollar are keeping up the pressure on EM countries with high debt and a dependence on foreign financing.

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Market returns 31.8.2018

Fixed Income	Return 1 mth	Return 2017	Return 1 yr
JPM Money Mkt	0,0 %	-0,2 %	-0,3 %
JPM EMU Govt	-0,6 %	-0,3 %	-0,2 %
Barcleys Infl.Linked	-1,0 %	-0,8 %	0,7 %
JPM Credit Index	0,2 %	0,0 %	0,2 %
JPM High Yield	0,1 %	0,2 %	1,4 %
JPM GBI EM Divers. (LC)	-5,6 %	-7,6 %	-8,1 %
JPM EMBI+ (HC)	-3,1 %	-7,3 %	-7,7 %
Equity Markets (Local currency, Net Total Return)	**Return 1 mth**	**Return 2017**	**Return 1 yr**
OMXH Cap Helsinki	2,1 %	13,1 %	14,1 %
Euro Stoxx 50	-3,7 %	-0,9 %	1,8 %
Stoxx 600	-2,1 %	0,6 %	5,1 %
S&P 500	3,3 %	9,9 %	19,7 %
Dow Jones	2,6 %	6,7 %	21,0 %
Nasdaq	5,9 %	18,3 %	27,5 %
Nikkei (Japan)	1,4 %	1,5 %	18,6 %
Hang Seng (China)	-2,1 %	-4,1 %	3,1 %
India	2,9 %	14,5 %	23,2 %
Russia (RTS)	-6,7 %	-2,0 %	4,4 %
Brazil	-3,2 %	0,4 %	8,2 %
MSCI Europe	-2,2 %	0,3 %	4,9 %
MSCI World All Country	1,1 %	5,0 %	12,9 %
MSCI Emerging Markets	-0,5 %	-1,7 %	4,3 %
MSCI Latin America	-2,2 %	1,0 %	5,6 %
MSCI Eastern Europe	0,0 %	7,8 %	13,4 %

Alternative Investments	Return 1 mth	Return 2017	Return 1 yr
S&P Commodity TR	1,1 %	7,6 %	22,2 %
Oil (spot)	3,2 %	18,9 %	39,6 %
Gold (spot)	-2,2 %	-9,5 %	-10,2 %
HFRX Global HF	0,2 %	-2,7 %	-1,5 %

Foreign exchange	31.8.2018	31.7.2018
EURUSD	1,16	1,17
EURJPY	128,84	130,79
USDJPY	111,03	111,86
EURGBP	0,90	0,89
EURSEK	10,60	10,28
EURNOK	9,73	9,54
Interest rates		
Fed	2,00	2,00
ECB	0,00	0,00
BoJ	-0,10	-0,10
BoE	0,75	0,50
Euribor 3m	-0,32	-0,32
Euribor 12m	-0,17	-0,18
Germany10y	0,33	0,44
iTraxx Europe 5y (IG)	68,26	61,90
iTraxx Crossover 5y (HY)	299,32	283,35

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

Fixed Income

Past Situation

Stable fixed income markets in the west

Europe's core inflation once again fell to 1% and is causing raised eyebrows at the ECB. The good news is, however, that payroll development for negotiated contracts has been more than +2% in Europe, which means that Europe's wages are starting to rise, following in the footsteps of the US. Italy's situation has not calmed down, as the country's government bond interest rates in late August come close to this year's peaks (in May). The ratings agency Fitch gave its Italian government bond credit rating (still IG) a negative outlook, which raises the likelihood of a high yield scenario. A high yield status would further impede the ECB's possibilities to support Italy's government bond markets while it continues its government bond purchases under the QE programme. This would mean increasing turbulence on the financial markets and pressure on the Italian banking sector. This will not be eased by the populist-toned increase in the budget deficit implemented by Italy's current government – against the EU's policies.

Italy will remain in the focus of the markets this autumn with the risk of one of the government coalition parties pulling out, due to unfulfilled election promises, which would result in new parliamentary elections. At the same time, following a long break, Italy is planning to issue USD denominated government bonds in order to expand its investment base when the active phase of the ECB's QE programme is wound up at the end of the year. So, nothing new on the southern front.

Current Situation

Nordic corporate bond markets thriving

As usual, the ending of the earnings season activated the post-holiday new issue markets for corporate bonds. In Europe, by the end of August, EUR 184 billion in new corporate bond issues were made, which fell just short of the record year 2017. Also in the Nordic countries, the end of August immediately ignited the new issue markets. We have been extremely selective when it comes to new issues as credit risk premiums are still very tight in the big picture despite this year's slight widening. In some cases, we felt that the loan documentation left room for improvement, which is another reason why we decided not to invest in new bonds.

The Nordic high yield market has performed well as a whole: our ML Nordic High Yield strategy rose +4% by mid-September, while the corresponding European high yield index is barely positive. Credit risk premiums are still wider in the Nordics but especially interest rate risk is significantly lower. Whereas the interest rate duration of our High Yield portfolio is 0.4 years, the interest rate duration of the euro high yield index is correspondingly 4.4 years. The sensitivity of our portfolio to interest rate rallies is thus only a fraction of the European general markets'. Also, in any case, the loan documentation is even higher quality from investors' perspective in Nordic high yield bonds (not necessarily in Finnish bonds), which is why we continue to see Nordic high yield bonds as interesting in this interest rate environment. There is still reason to be selective and, so far, the ML Nordic High Yield investment basket has participated in just three new issues after the summer holiday period.

The Future

Central banks reducing stimulus measures

In its autumn meeting, the ECB forecast the euro zone's GDP growth as +1.8% for next year and +1.7% for 2020. The central bank's inflation forecast remains firmly at +1.7% for the next few years. The starting up of the interest rate hike cycle in the euro zone is forecast for autumn 2019, which is a relevant timetable in our opinion. The momentum of euro zone economic growth has seen a slight slowing down as, for instance, Italy's GDP growth dwindled in Q2 and is now just +1.2% year-on-year (previous +1.4%). However, the latest inflation development insight supports the ECB's situation, for example, in Southern Europe where payroll development has begun to rise slightly after a break of several years.

Inflation expectations in the US are also slightly on the rise; the latest consumer surveys from the University of Michigan show that long-term expectations are as high as 2.6%. This reflects the rise in pay pressure, which is clearly above 3% in the US. We forecast that the Fed will carry out two more interest rate hikes this year.

Sweden and Norway are preparing for key interest rate hikes and thus we predict that the krona and krone will appreciate both against the euro and dollar. The interest rate hikes will take off relatively slowly in any case. Norway's first interest rate hike will take place in September. In both countries, our attention will be focussed on a possible change in the consumption behaviour of households and the situation in the housing markets once the interest rate hike cycle takes off.

In western countries, the turning of the central bank cycle in the footsteps of the Fed is finally gaining steam. Among EM countries, those already equipped with weak fundamentals are in trouble. In Argentina, the central bank raised its key interest rate to 60% (inflation more than 40%) and Turkey finally raised its key interest rate to 24% to defend its currency. In our view, there is no rush to enter the emerging fixed income markets as globally declining dollar liquidity, together with trade war issues, is a major negative factor for many EM countries.

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Equities

Past Situation

US equity markets reach new highs

It is now, in mid-September, ten years since the Lehman Brothers financial group filed for bankruptcy, and risky asset classes are continuing to rise universally from the 2009 trough. The US equity markets are the strongest of the broad markets, but Finland's main index has performed even better (in local currencies, dividends factored in). In the US, companies' earnings growth is largely better than in the euro zone, taking into account the fact that already in 2011 the joint earnings of US companies rose above the pre-financial crisis level. In Europe, the Stoxx 600 index is still below financial crisis levels in terms of companies' earnings. This explains the weaker performance of European stock markets compared to US stock markets this cycle.

This year, the rise in US stock markets in relation to the broad European indices and EM stock markets has been historically significant. The S&P 500 index rose +9.9% by the end of August, while at the same time the Stoxx 600 index has yielded just +0.6% (in local currencies). Many technology companies have ascended in the US to valuation levels (with traditional valuation indicators) that allow us to talk about overheating on the market when it comes to individual companies. But, as a whole, for example in terms of the S&P 500 index's 12-month forward-looking earnings growth forecast, the index's P/E ratio is approx. 17x, which is not extremely expensive by any means. On the same scale, in Europe, the Stoxx 600 index's P/E ratio is just around 14x. Earnings growth has thus supported the rise in the equity markets. EM stock market indices are starting to turn towards a bear market (decline of more than –20% from the previous peak), led by China's local markets. The stock markets of emerging markets have been subject to sales due to an escalation of trade war rhetoric.

Current Situation

Earnings development still strong in the US

It is clear, after the Q2 earnings reports, that the earnings performance of US companies has remained spectacular. Earnings are still expected to grow approx. +23% this year and +10% next year. US forecasts have even been slightly elevated since Q2 with the telecommunication and health care sectors subject to forecast hikes. The lightening of corporate tax in early 2018 is now behind us and earnings development is now supported by the good situation in the real economy. The unemployment rate is less than 4% and the US is experiencing practically full employment. The bar is set relatively high after earnings forecasts were raised, so there is little room for earnings disappointments at these levels. In Europe, earnings development was more moderate in Q2. Stoxx 500 index companies' earnings are expected to grow approx. +8.2% this year and +9% next year. The recent dwindling of economic momentum in Europe (evident in PMIs, for example) has put some downward pressure on market earnings forecasts. Nevertheless, we are still on a good track with European companies' earnings finally growing. We are, however, still firmly stuck below pre-financial crisis levels in terms of earnings growth.

Trade war issues are affecting European companies at the moment because many export companies manufacturing investment commodities have direct links to Asian demand and the development of global trade. EM stock markets are currently experiencing the largest decline in earnings forecasts, but they are still at better earnings growth expectation levels than Europe, in absolute terms. The markets expect earnings growth of +15% for the MSCI-EM index for this year and +11% for next year. The EM stock markets are currently experiencing a flow of redemptions, especially with US investors diverting their assets towards their home country.

The Future

Real threat of trade war – EM under pressure

Thanks to the rise in equity prices and good economic performance, US consumers' confidence in the future is at its highest in 17 years. The correlation of confidence with the development of net asset values is strong, and the old upward equity trend is currently fuelling households' consumption behaviour.

Using leverage in the US to buy equities, i.e. margin debt, is currently at around 3% in relation to the US GDP, which is quite a lot. At the same level, the US equity market has earlier shown signs of turning downwards. Currently, however, earnings growth momentum is strong and there are no distinct signs of a turnaround in the trend. The trade war would be one of these negative factors, if it were to escalate. It is unlikely that the imbalance in trade between China and the US will be corrected amicably due to the various duties and tariffs. Both parties have major stakes in the game. If the US sets the next USD 200 billion in import duties on Chinese commodities, the Chinese yuan's situation will move into the spotlight. The impact of previous duties was buffered in China with the de facto devaluation of the yuan, but the excessively fast depreciation of the currency creates inflation pressure and thus pressure to raise interest rates. China has just achieved an improvement in short-term growth prerequisites with an injection of stimulus, and a tightening monetary policy would not currently suit the EM stock markets' risk appetite. China's and other EM countries' share of the global economy is growing all the time and they are thus integrating more closely with the western markets.

Trade war issues were discussed more by companies in connection with Q2 reporting than tax cuts. This is starting to be a running theme on the markets with the approach of the US midterm elections. Despite the risks on the surface, our insight is that, in this economic cycle and due to the current earnings growth rate, the equity markets still offer better prerequisites for a rise in value than low-risk fixed income instruments.

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Alternative Investments

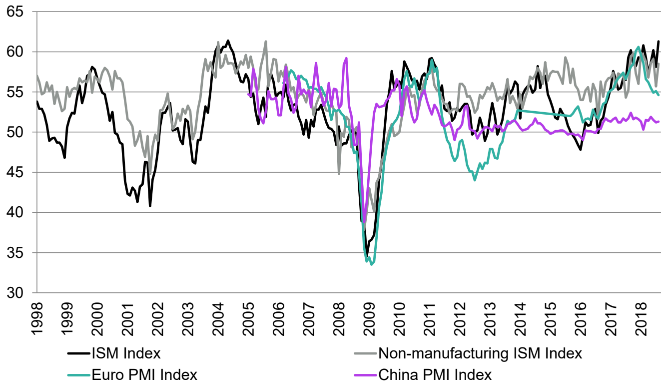
The low level of risk-free interest rates particularly in the euro zone is still pushing investors towards asset classes with no daily redemption opportunities. This way, investors are looking for higher yields resulting partly from this weaker liquidity and the related liquidity premiums. This is well-suited to many investors' portfolios.

By early 2018, the investment capacity in European private debt funds had not, in the light of statistics, risen much above the earlier levels, but this development has changed, and the amount of dry powder has significantly increased. 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. Typically, a growing volume of investment capacity increases competition for good investments and makes it harder to discover them. In our view, as a whole, the market situation is still favourable for private debt investments, from the perspective of long-term investors, particularly compared with traditional asset classes.

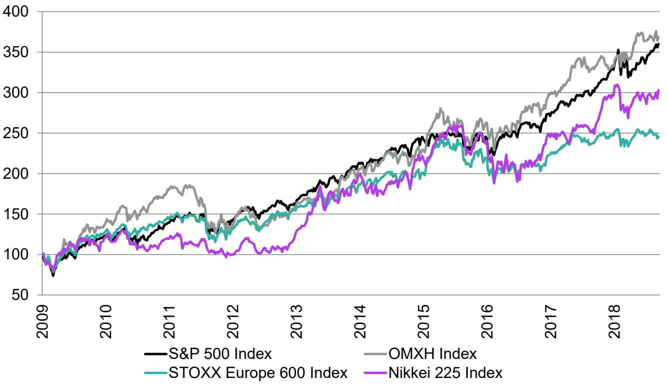
On the private equity markets, valuation levels are at an all-time high. The performance of private equity funds last started up at these valuation levels between 2006 and 2007 remained modest once the financial crisis hit the markets in 2008. At the moment, the volume of investment capacity in private equity funds is at an all-time record level and we have continued to be extremely selective in making new investments. 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 a 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.

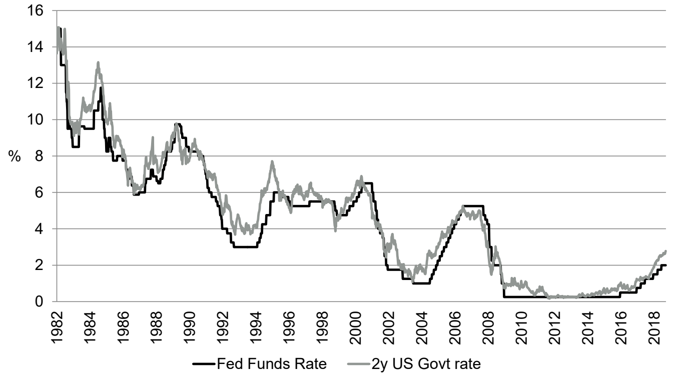
PMI Development



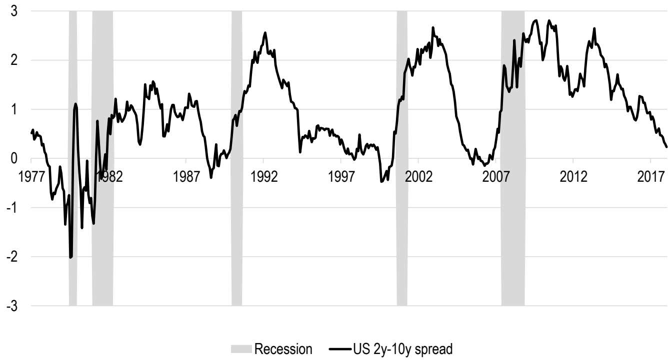
Equity Index Development (2 Jan 2009 = 100)



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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