MANDATUM LIFE

Market Outlook

7 November 2017

Economic growth possibly accelerating in US

Equities continued to rise in October. The third quarter earnings season took off and has, so far, been stronger than expected. In the US, the rate of earnings growth has been more than +8% and in Europe more than +5%. At the same time, the global economic growth outlook is well-supported, with improved corporate earnings, a low interest rate level and central bank stimulus maintaining a global GDP growth rate of around +3.6%. In the US, GDP growth is even regaining momentum with Q3's reported growth at as high as +3% annually. We are maintaining the equity markets' weight at neutral, with small sales made during the year balancing out the good generated by rising stock prices in the portfolios.

In October, interest rates remained within a narrow variation range in the euro zone. The ECB's QE programme's monthly purchases will be reduced to EUR 30 billion at the beginning of next year, but it looks like the first key interest rate hike will probably not take place until summer 2019. As we see it, the Fed's next key interest rate hike will take place in December and it is already actively reducing its balance sheet. The size of central bank balance sheets has correlated strongly with risky asset classes following the financial crisis, so this is worth keeping an eye on.

Credit risk premiums tightened some more in October, both in Europe and in the US, with the good earnings season reinforcing companies' outlook. Cash is currently cheap due to the low interest rates and the tightest credit risk premiums this cycle. It is not surprising either that, especially in the US, the quality of documentation for corporate bonds' new issues (incl. covenants) has fallen significantly. At the moment, there is reason to be careful when deciding which issues to participate in. The high demand for corporate bonds is unlikely to ease up in the next few months.

The equity markets rose to new all-time highs in the US, boosted by a good start to the earnings season. The technology sector has been especially strong, but also the development of the material and construction sector is good. The strengthening of the euro came to a halt, but it added some negativity to the earnings outlook of euro zone export companies. All in all, the earnings season has taken off better than expected in the US with S&P 500 companies reporting earnings growth of even more than +8%.

There have been no signs of the feared earnings weakness, which has given equities room to rise to new highs in the US. At the same time, valuation levels have risen to their most expensive this cycle, but there are reasons behind this. In Europe, the currently reported earnings growth has been more than +5%. Earnings forecasts have carefully been raised during the Q3 earnings season, so no major challenges are in store on this front in upcoming weeks. S&P 500 companies are expected to reach +11.8% earnings growth next year, and Europe's Stoxx 600 companies +8.7% similarly.

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

Market returns 31 October 2017

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

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

Equity Markets (Local currency, Net Total Return)	Return 1 mth	Return 2017	Return 1 yr
OMXH Cap Helsinki	0,9 %	14,0 %	21,0 %
Euro Stoxx 50	2,3 %	14,3 %	23,3 %
Stoxx 600	1,9 %	12,0 %	19,7 %
S&P 500	2,3 %	16,9 %	23,6 %
Dow Jones	4,4 %	20,6 %	32,1 %
Nasdaq	3,6 %	26,1 %	31,1 %
Nikkei (Japan)	8,2 %	17,1 %	28,7 %
Hang Seng (China)	2,6 %	33,2 %	28,0 %
India	6,3 %	26,3 %	20,5 %
Russia (RTS)	-1,7 %	0,6 %	18,9 %
Brazil	0,0 %	23,4 %	14,5 %
MSCI Europe	2,0 %	11,7 %	19,5 %
MSCI World All Country	2,7 %	16,8 %	22,2 %
MSCI Emerging Markets	3,9 %	28,3 %	25,7 %
MSCI Latin America	-0,3 %	19,4 %	12,5 %
MSCI Eastern Europe	0,8 %	4,1 %	16,2 %

Foreign exchange	31.10.2017	29.9.2017
EURUSD	1,16	1,18
EURJPY	132,34	132,92
USDJPY	113,64	112,51
EURGBP	0,88	0,88
EURSEK	9,76	9,63
EURNOK	9,51	9,41
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	-0,19	-0,17
Germany10y	0,36	0,46
iTraxx Europe 5y (IG)	50,23	56,96
iTraxx Crossover 5y (HY)	225,93	253,82

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

Fixed income

Past situation

ECB announces cutback of balance sheet purchases

The ECB announced it would be cutting back its balance sheet stimulus purchases on the European bond markets to EUR 30 billion per month from the start of next year. At the same time, EUR 15 billion in loans falling due will be reinvested. The fact is that, for example, Germany's bonds and those of other higher credit-rated countries are beginning to be scarce at the ECB's purchase volumes, which played a part in the ECB's decision.

However, more significant in terms of the decision was that economies are recovering at a good rate in the euro zone and inflation is slowly beginning to wake up from its slumber. There is thus no longer any reason to continue the growth injections through these types of stimulus purchases. Germany is growing at a rate of around 2% and France is slightly below this at the moment. The situation in Catalonia (approx. 20% of Spain's GDP) has raised questions concerning the whole of Spain's growth expectations, but at least for now, the damage to the economy has been minor. Spain's GDP rose further in Q3 but clearly more strongly than the rest of the euro zone, at +3.1% annually, which means that, due to its size, Spain's input into euro zone growth is the second largest (measured in absolute euros) after Germany. This is why the Catalonia issue is also important in terms of growth.

Interest rates moved slowly within a narrow variation range in the euro zone. In the US, government bond rates rose slightly with Trump's tax reform likely to increase the budget deficit. In the US, the interest rate on 10-year government bonds has risen to the critical 2.4% level. When we reach a slightly higher level than this, we can declare the decades-long downward trend in interest rates to be over.

Current situation

High demand for corporate bonds continues

The ECB's announcement that it will reduce balance sheet purchases has yet to cause panic on the European corporate bond markets. On the contrary, the ECB can be expected to even further reduce its government bond purchases and, correspondingly, the relative share of corporate bonds with better credit ratings (BBB- or above) in the purchase pool. This kept credit risk premiums tightening also at the end of October. Higher risk corporate bonds' credit risk premiums have narrowed even more in Europe and the US. At the same time, loan documentation has already been slipping for quite some time, especially in the US, as companies see little need for such tight loan terms – bonds are selling anyway.

From the investor's standpoint there is reason to be extremely selective when it comes to choosing which issues to participate in at this stage of the cycle. The prevailing credit risk premium level, for example in the European high yield market, does not include any type of buffer for a possible return of default rates to the longer-term average. The current credit risk compensation for investors is fine if next year's defaults on the euro high yield market come to 1% and the recovery value from bankruptcies for corporate bonds is some 60%. We do not see this type of market situation as relevant for next year.

The start of the earnings season, for the most part, quieted the new issue front in the Nordic corporate bond markets, but demand remains high. The forward-looking return level of our ML Nordic High Yield investment basket is currently at slightly above 5%, practically without interest rate risk, which is a good level compared to Europe.

The future

Economic growth possibly accelerating in US – inflation still low

Despite the strong economic growth level (Q3 GDP +3.0% in US), inflation is still relatively moderate. In the US, the price deflator for US private consumption was +1.3% in Q3 and September's inflation figure was +2.2%. In the comprehensive consumer survey conducted by the University of Michigan, inflation is forecast to be about 2.4% in the long run. At the moment, despite the tightness on the labour markets, the US economy does not contain the types of bottlenecks that would cause wage-push inflation to surge upwards. Thus, the Fed is able to communicate a calm key interest rate hike rate and, on the other hand, that the reduction of the balance sheet will be a long-term undertaking.

In the euro zone, the latest inflation figures showed prices climbing just +1.39% in October, which resonates well with the ECB's moderate stimulus policy. The situation may, however, change suddenly if the prices of oil and industrial metals continue to rise at their current pace. The positive economic momentum is global and the rise in raw material prices also reflects this. A surge in the oil price, for instance to USD 70 per barrel, seems to be a remote possibility right now, but may be likely within a couple of years. The central banks' attitude will be different on a number of fronts and inflation expectations will be rising. The interest rate level would react to this quickly with the main central banks, perhaps with the exception of Japan, already starting up their winding down of stimulus measures.

We still consider the management of interest rate risk to be a key element in our fixed income investments, and we are prepared to reduce our portfolios' interest rate risk sensitivity even more if the need emerges.

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Equities

Past situation

Equities continued to rise

The equity markets continued to rise in October with all key indices in the green. In the US, the main indices leaped to new all-time highs, aided by a positive Q3 earnings season. The S&P 500 index has risen 16.9% from the start of the year, and from the euro investors' perspective, just 5.9% due to the weakening of the dollar this year. The expectations concerning the passing of Trump's tax reform have maintained a positive momentum, but altogether, good economic development and the strong earnings season have so far been the real economy fundamentals that supported the equity markets also in October. The Stoxx 600 index in Europe has risen +12% as of the beginning of the year and economic growth has met or even exceeded market expectations.

The very best upward movement on the equity markets was seen, however, in emerging market (EM) stock markets. Hong Kong's Hang Seng index is up +33% from the start of the year. Brazil's main index has risen +23%, driven by raw material prices. Industrial metals have adjusted upward strongly, which supports the earnings performance of many EM exporters. Similarly, global trade indicators on trade flows are still rising, which will benefit EM countries many times over due to production outsourcing.

The rise in stocks has still pushed price volatility indicators downwards and the VIX index, describing the markets' volatility, has remained firmly at below 12 points, which indicates a strong upward trend in equities. Thus, the investment flow to the equity markets has remained steady and, most recently, Japanese funds in particular have begun to increase the weight of the US in their portfolios

Current situation

The earnings season has been successful

The Q3 earnings season started in October and in the US it has proceeded, for the most part, even stronger than expected. At the turn of November, when more than half of S&P 500 companies had issued reports, earnings growth per share was more than 8% compared to a year earlier. Final demand has thus remained strong and the US third-quarter GDP was also rising by +3.0%, likewise above forecasts. The US economy is now experiencing a positive momentum. In Europe, the Q3 earnings season has pretty much proceeded as expected, with earnings growth at approx. +6.0%. The most positive earnings surprises came from the technology and banking sectors.

Globally, 2018 earnings forecasts have been raised during this earnings season, which means that the building of support for the continued rising of equities has begun. Earnings forecasts have, in fact, been raised the most in Japan. At the moment, in the US, S&P 500 companies are expected to reach 5.1% net sales growth this year and +11.8% earnings growth next year at this sales rate. The strongest changes in forecasts recently have occurred in the material and energy sectors, as the increase in raw material prices supports earnings growth expectations.

Something similar can be seen in the Nordics where mining companies had full order books in Q3, due to a growth in demand for investment commodities. All in all, the earnings forecasts for the Nordics were raised (net) during the Q3 reporting season. In Europe, the Stoxx 600 companies' earnings forecast for next year is +3.5% with growth in sales of +8.7%. This also indicates that profit margins are not anticipated to experience weakness next year. In other words, earnings growth expectations are at a strong level, so there is no room for disappointments. In fundamentals, the recent support provides a good foundation for the equity markets to continue rising.

The future

Equities risen – good earnings

Although equity market valuation factors have risen to their post-financial-crisis peaks on the main markets, earnings growth has also been positive. In the US, the S&P 500 index's forward-looking 12-month P/E ratio is around 18, which is by no means cheap, but not impossibly expensive either, if earnings forecasts hold true.

Valuation level observations reveal that, in the US, S&P 500 companies' earnings accrual already exceeded pre-financial-crisis levels in 2011, but Europe is still clearly below these levels. Struggling earnings growth has long been a burden on Europe, but the situation has now taken a U-turn and small companies are doing well. The ongoing Q3 earnings season only confirms that an earnings turnaround has already happened in Europe.

Elections are coming and going in the euro zone, and integration supporters and opponents are butting heads on a regular basis. Good companies are, however, able to operate in different types of environments, an example of which can be found in Catalonia, where a group of larger companies quickly transferred their head office to Madrid when uncertainty grew. The recovery of the banking sector is at the core of the European large cap company index. The rising of interest rates as the economy recovers is tackling this issue – albeit slowly. An exceptional situation is currently ongoing in the global economy in that the growth outlook is improving in all the main economic areas. Companies' confidence indices are at the cycle's highest levels and even rising. Earnings performance is good, raw material prices are rising and the central banks' major stimulus measures are still open in the big picture. We have remained in a neutral position in terms of equities and will continue to hold this position as we approach year-end.

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Alternative investments

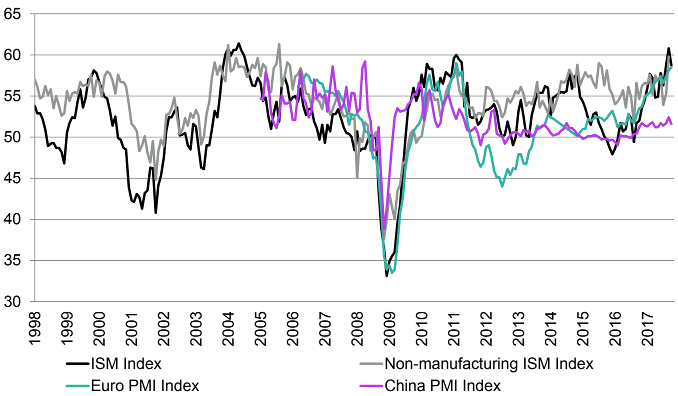
With regards to alternative investments, no major changes are at hand. The low level of risk-free interest rates globally and particularly in Europe is still driving investments to asset classes which do not have daily redemption opportunities. Thus, investors are looking for higher yields resulting partly from this weaker liquidity and the related liquidity premiums. This is well-suited to many investors' portfolios.

The volume of dry powder in European private debt funds has not grown significantly, especially in light of statistics, despite the ongoing raising of funds. New investment opportunities are steadily flowing onto the private debt markets with, for instance, the tightening of banks' regulation framework opening up new material to investors. In the market's most illiquid section, yield levels on new private debt bonds have not fluctuated very much globally since 2013. In our view, the market situation is still relatively positive for the Mandatum Life Private Debt investment baskets, from the perspective of long-term investors, particularly compared with traditional asset classes.

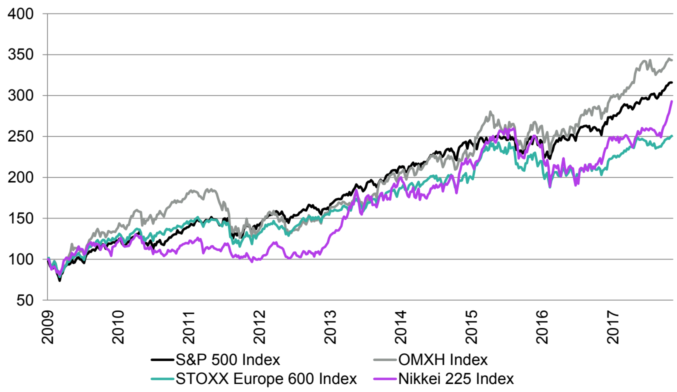
The private equity markets' valuation levels are starting to be at their all-time highest levels. The performance of private equity funds last started up at these valuation levels between 2006 and 2007 remained low once the financial crisis hit the markets in 2008. At the moment, the volume of dry powder in private equity funds is at an all-time record level.

On the European real estate markets, and especially for core properties (best offices in city centres), yields have fallen to their all-time lowest level due to high demand and the low interest rate level. At the same time, the valuation levels of properties operating below their potential (e.g. half-empty office premises etc.) have not risen correspondingly. Due to the core market situation, our Mandatum Life International Real Estate investment basket is focusing on investments in so-called value add and loan-form properties where we still see good return potential.

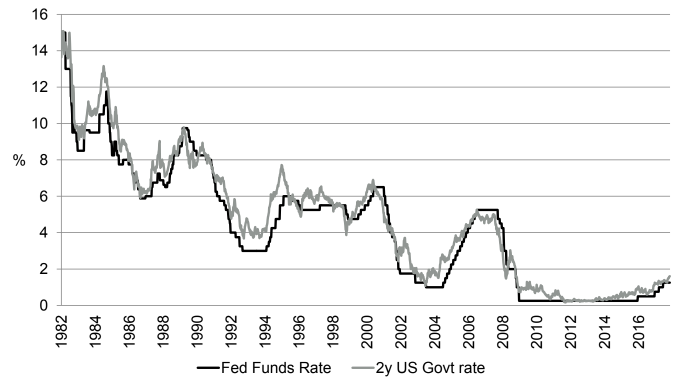
PMI development



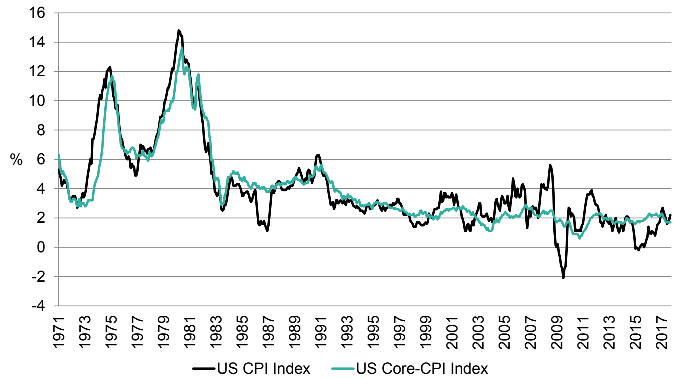
Equity indexes (2.1.2009 = 100)



Fed funds rate and 2y government bond yield



US consumer price index and underlying inflation



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

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