Economic & Investment Outlook

Navigating the new interest rate environment

Ingus Grasis

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What a world!

Source: Robert Bergqvist, SEB Chief Economist

Three categories of threats

Heightened geopolitical uncertainty

- A world where US dominance is no longer self-evident and where various actors, especially Russia and China, are seeking new roles.

Uncertainty about the future of the euro

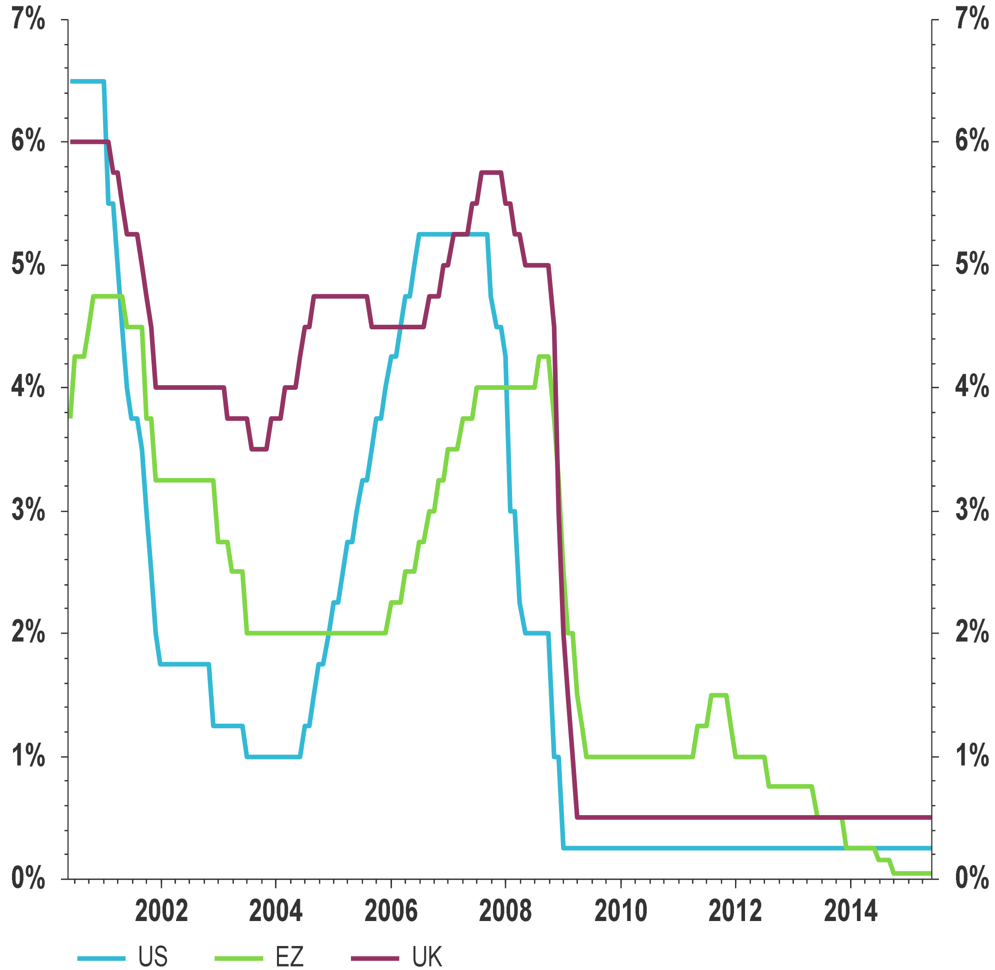
- Even if it is not our main scenario, the probability of Greek exit from EZ increases. The long-term consequences of the withdrawal should not be underestimated.

Uncertainty about QE policy & exit strategy

- How the massive central bank stimulus measures can be reversed without jeopardizing financial stability? Probably the most important threat.

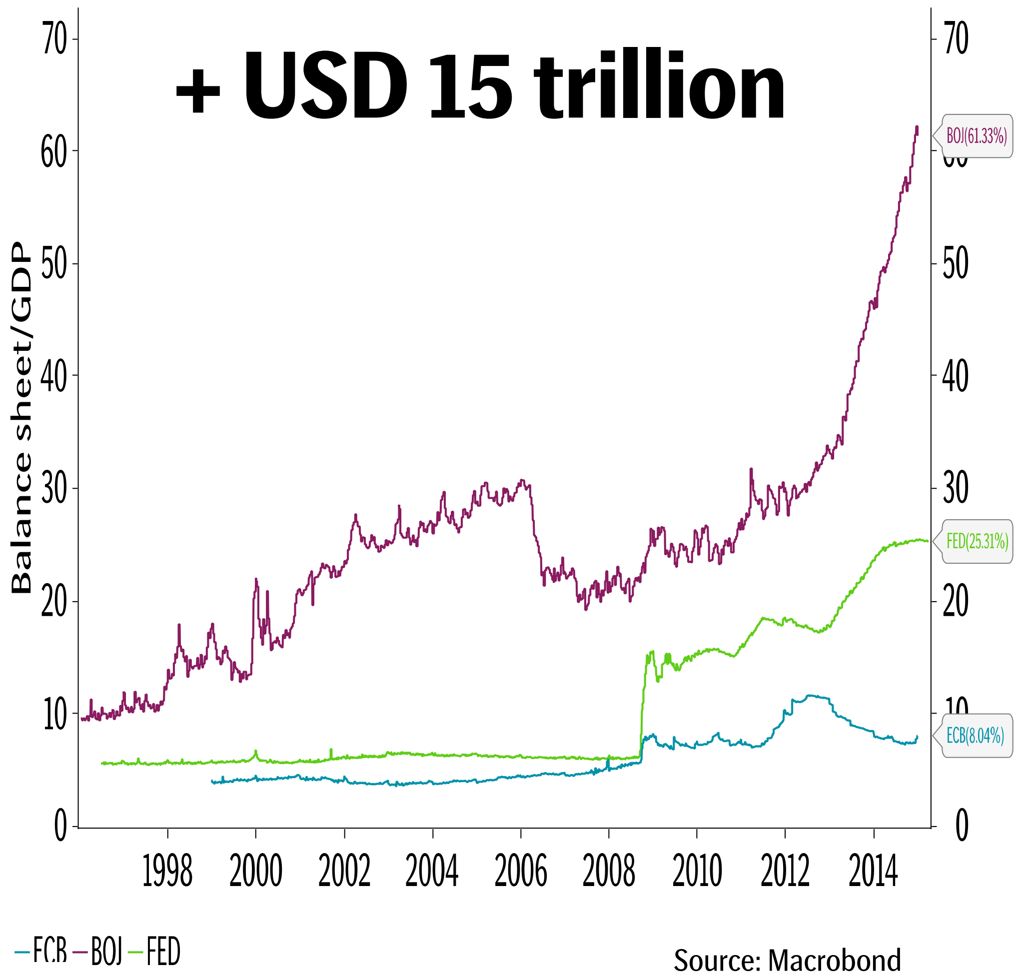
Central banks are «printing money»

Key monetary policy rates, % p.a.



Source: Thomson Reuters Datastream

Central banks balance sheets, % of GDP



Source: Macrobond

Long-term bond yields have decreased

Low bond yields because

- ✓ Deflation expectation
- ✓ Negative key policy rates
- ✓ More QE
- ✓ Regulations
- ✓ FX appreciation
- ✓ Fear

Major government 10-year bond yields

Source: Thomson Reuters Datastream

Unbelievable bond yield universe

Government bond yields (1-10 years to maturity)

	1	2	3	4	5	6	7	8	9	10
Switzerland	neg.	neg.	neg.	neg.	neg.	neg.	neg.	neg.	neg.	neg.
Germany	neg.	neg.	neg.	neg.	neg.	neg.	neg.	pos.	pos.	pos.
Finland	neg.	neg.	neg.	neg.	neg.	neg.	neg.	pos.	pos.	pos.
Netherlands	neg.	neg.	neg.	neg.	neg.	neg.	neg.	pos.	pos.	pos.
Denmark	neg.	neg.	neg.	neg.	neg.	neg.	pos.	pos.	pos.	pos.
Austria	neg.	neg.	neg.	neg.	neg.	neg.	pos.	pos.	pos.	pos.
Belgium	neg.	neg.	neg.	neg.	neg.	neg.	pos.	pos.	pos.	pos.
France	neg.	neg.	neg.	neg.	pos.	pos.	pos.	pos.	pos.	pos.
Sweden	neg.	neg.	neg.	neg.	neg.	pos.	pos.	pos.	pos.	pos.
Spain	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.
Italy	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.
Norway	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.
UK	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.	pos.

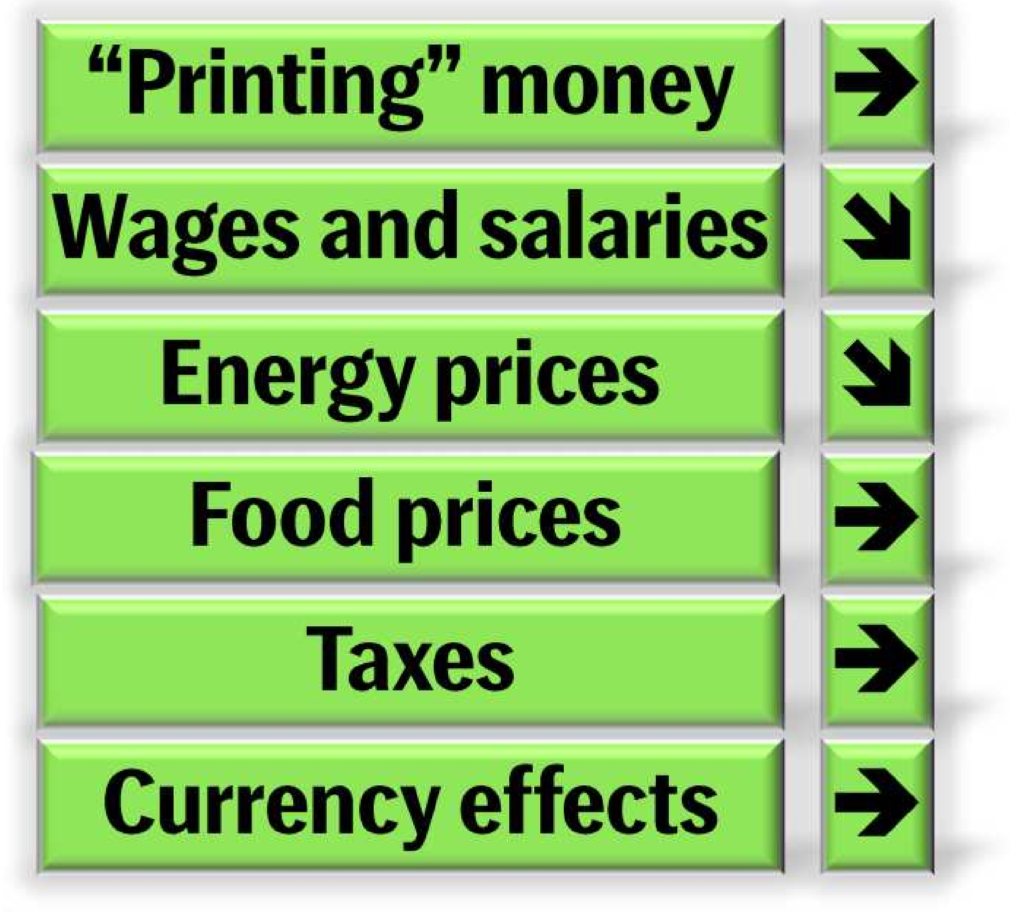
Monetary policies may create mispricing of risks

- CB policies want
  - improve credit supply
  - facilitate repairing of balance sheets
  - increase liquidity

- Greater risk-taking, global hunt for yield, and declining risk-absorbing capacity (new regulations) may lead to higher volatility in the future.
- Rising asset prices may cause potential bubbles in the future.

Inflation will remain low

- Falling oil prices dominate short- and medium-term inflation picture.
- Growing money supply in itself is not so important to inflation.
- Central banks and governments beginning to see the weak wage response as a problem.
- Likelihood that falling wages will drive economies into a deflationary spiral has decreased further.



Source: Robert Bergqvist, SEB Chief Economist

Monetary stimulus will continue

- FED will hike rates in September despite low inflation
  - Rates will increase slowly
  - USD exchange rate will not become a major issue
  - USD appreciation will not create excessive problems for EM countries
  - As long as the rate hikes are justified by an improved economy, they should not be a threat to the stock market
- Globally monetary policy will remain ultra-loose (ECB, Japan, China)
- Too early for ECB to «taper»

Key policy rates:

	Today	Dec-15	Dec-16
US	0-0.25%	0.75%	1.75%
EMU	0.05%	0.05%	0.05%
UK	0.5%	0.5%	1.25%
Japan	0.1%	0.1%	0.1%

FX rates:

	Today	Dec-15	Dec-16
EUR/USD	1.10	0.95	1.00
USD/JPY	121	130	140
EUR/GBP	0.71	0.66	0.67

Source: SEB Nordic Outlook, May 2015

Summary: Central bank driven recovery with untested tools

- US growth slump will be temporary this year too, household consumption will accelerate.
- Low oil prices, weak euro and ECB's QE program will help the euro zone.
- Hard landing in China is becoming less likely; economic policy easing will need to intensify.

Global GDP growth, YoY % change

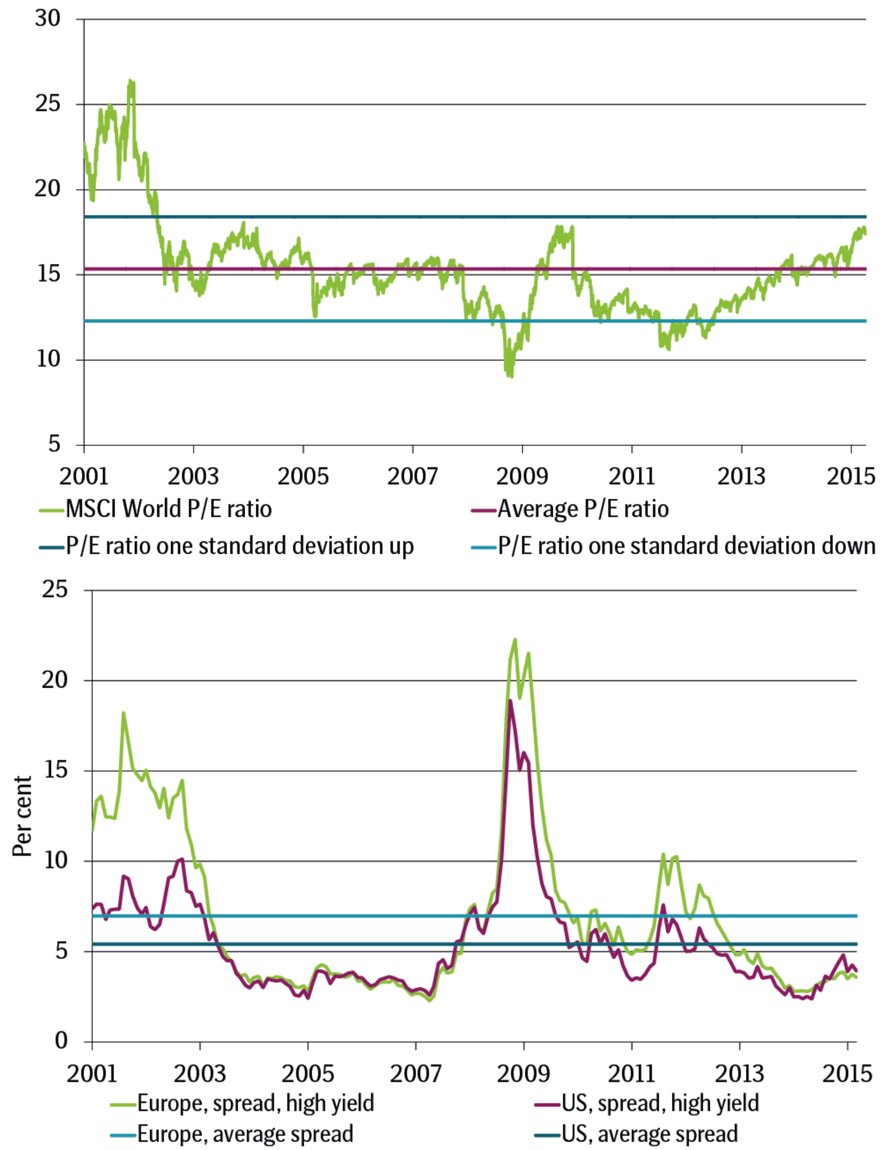
	2014	2015	2016
US	2.4	2.7	3.2
Japan	0.0	1.1	1.3
Germany	1.6	2.2	2.3
China	7.4	6.8	6.5
UK	2.8	2.5	2.4
Euro zone	0.9	1.7	2.1
OECD	1.9	2.3	2.7
EM	4.7	4.3	4.9
World, PPP	3.4	3.4	3.9

Source: SEB Nordic Outlook, May 2015

Implications for investors: no longer any cheap assets

- All assets have risen in price, and none is cheap.
- Parts of government bond markets are the most expensive asset class.
- Stronger expected economic growth will improve earnings, thus benefiting equities and corporate credit more that government bonds.
- Due to the actions of the central banks and continued low inflation, interest rates and bond yields should rise at a slow pace.
- Today the real economy poses no major threats to equities. Investors are more focused on central banks. It will be hard for them to make a smooth exit.

Global stock market valuations & HY bond spreads



Source: Bloomberg

Ingus Grasis

Investment Strategist

SEB Private Banking

ingus.grasis@seb.lv

AS "SEB banka"

Tālrunis: +371 6 777 9799

Vaļņu iela 11, Rīga

LV-1050

http://www.seb.lv