Economic Outlook

In growth we hope, but in low rates we trust

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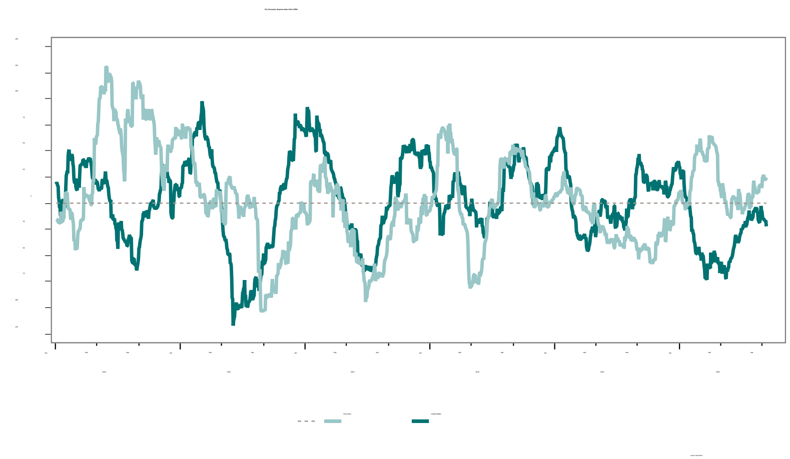
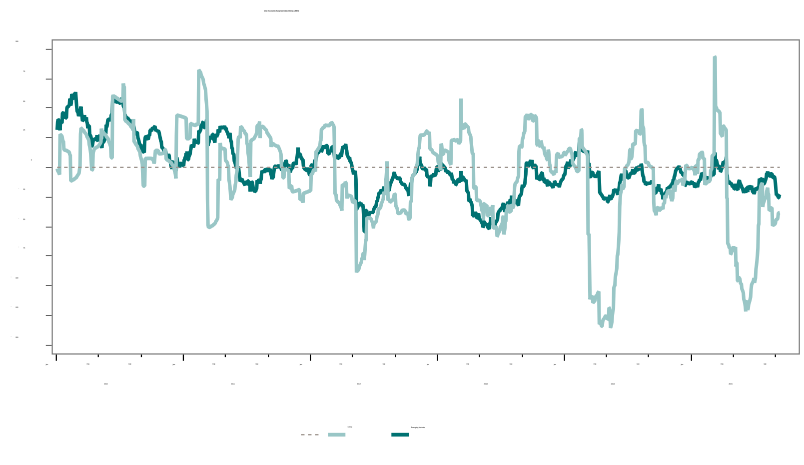
Global economy: short-term momentum – a lot of concerns, but how bad is it?

- Despite markets' concerns about global growth, data is not all that bad, particularly for the Develop World.
- The Eurozone is actually doing a little better than expected and the US is in line with expectations. Thus, we do not expect forecasters to have to reconsider the expected cyclical recovery during H2.
- If the outlook for Develop World looks stable, it is more uncertain for Emerging Markets and particularly for China where data is undershooting expectations. The situation in China is more complex given the huge internal imbalances, meaning growth looks set to underperform expectations for some time.





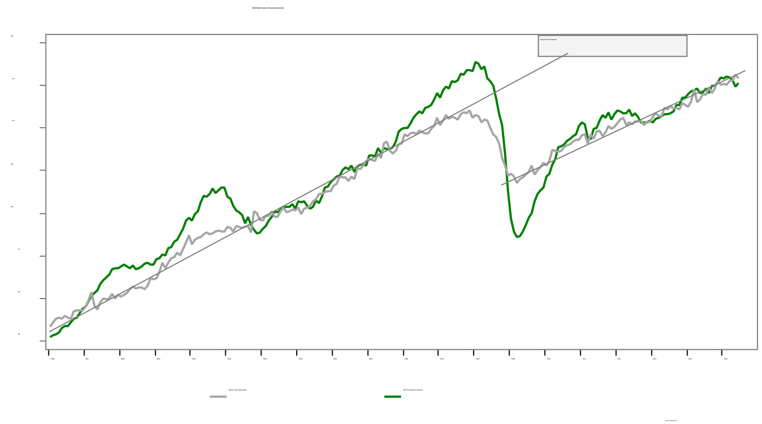
Where do we stand? The case for optimism and pessimism

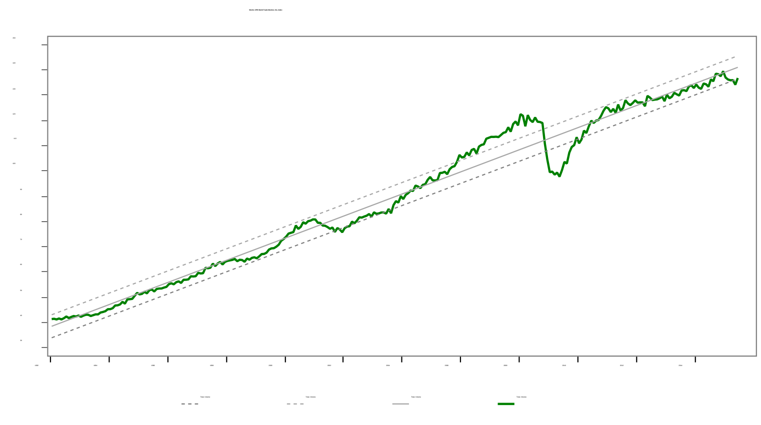
Case for optimism:

- Private sector cash flow remains strong and balance sheet consolidation is mostly done.
- Despite that Fed looks likely to hike rates later this year – ‘whatever it takes’ central banks remains the norm.
- A prolonged period of soft private sector demand in the OECD makes the pent-up demand story more likely.
- Falling commodity prices are a boost to household consumption.

Case for pessimism:

- Correction of the investment overhang in China.
- Slump in commodity prices could further hamper an already weak investment cycle.
- Higher volatility in asset prices – lower ‘wealth effects’ for the household sector.





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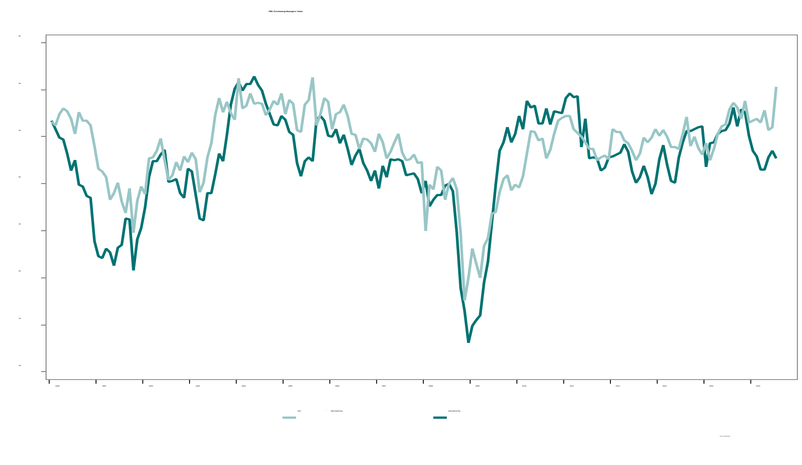
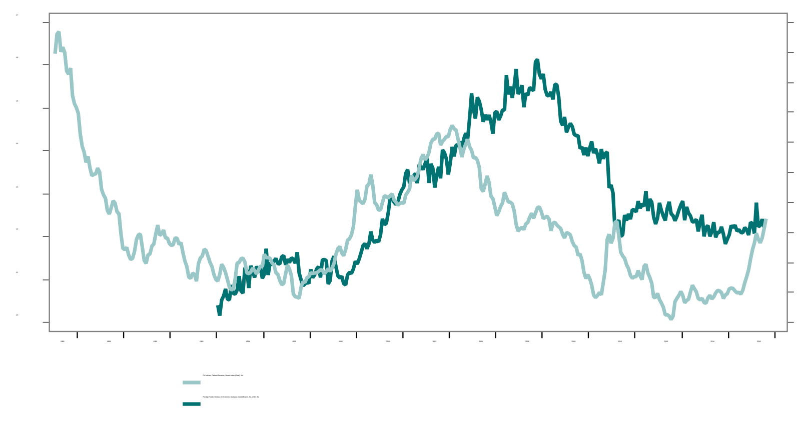
The US: promising domestic growth outlook in the short run…

- Falling commodity prices and a strong labour market point to healthy domestic demand as income growth gets a boost.
- The private sector (particularly the corporate sector) continues to increase spending faster than it is generating income, supporting growth in the short run.
- The outlook for manufacturing is more mixed as a stronger USD and weak growth in export markets take their toll on growth.
- All in all, the short-term trend looks rather solid for the US economy and we expect positive growth momentum into 2016.





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…but sustained growth expectations near 3% could prove more challenging

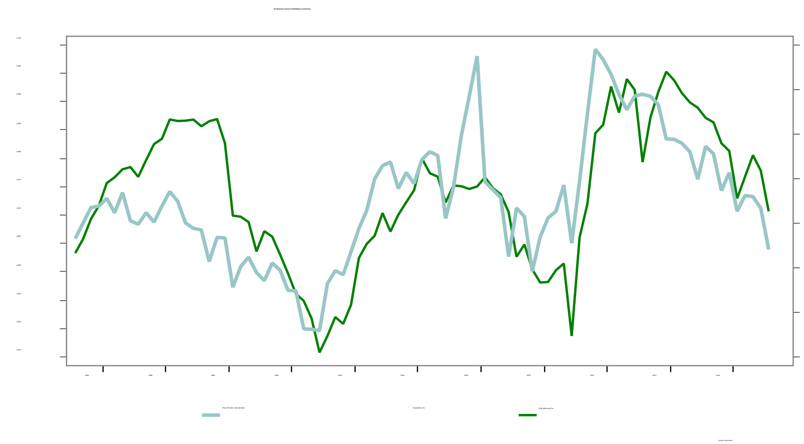
- Consensus of 3% growth for the coming years could prove challenging as the stronger USD and weak export market growth start to have an impact…

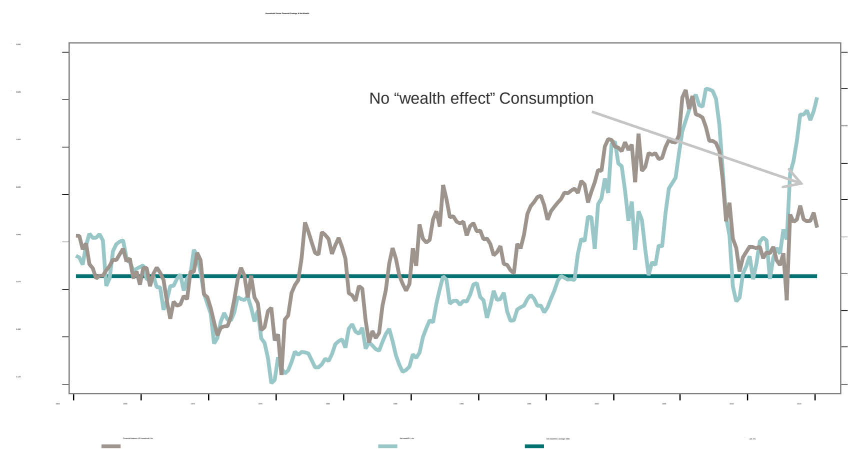
- …hence the recovery looks set to depend on the private sector driving demand, which would be equal to more leverage, particularly with the current fiscal stance.

  - This could be done through a further reduction of savings in the corporate sector – but profitability, although high, is falling.

  - Or by a rising debt to income trend in the household sector.

- Would this be a plausible scenario in a environment of rising yields and richly valued asset prices?





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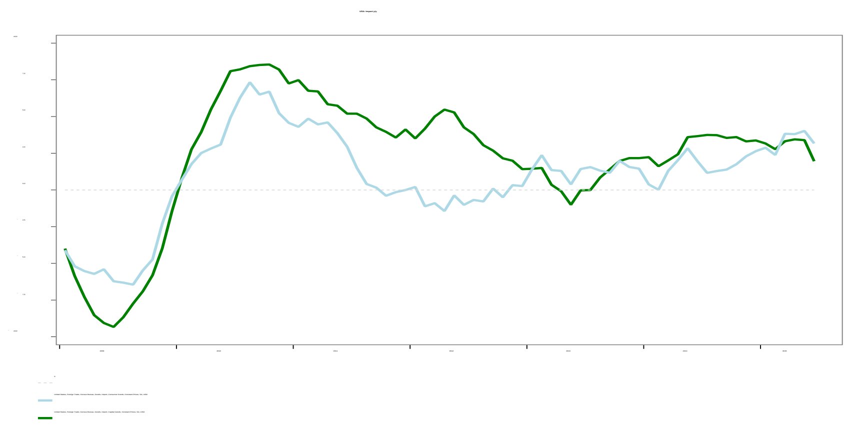
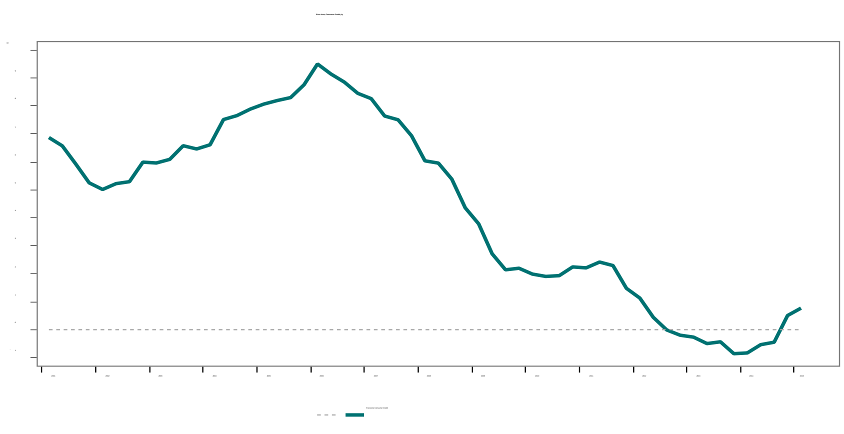
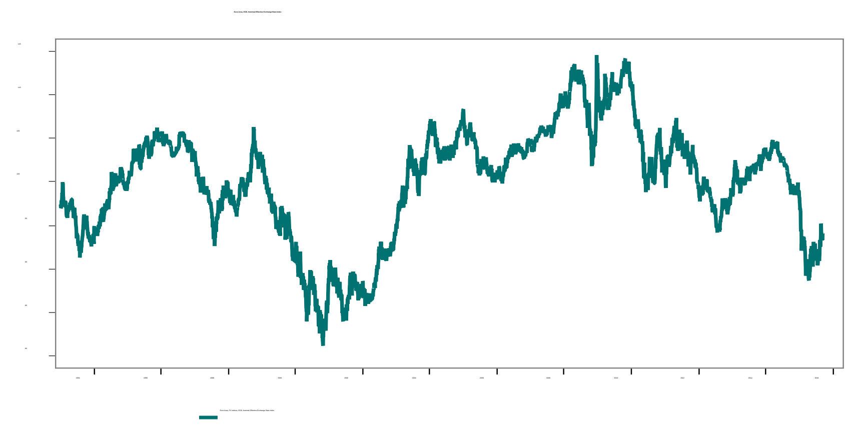
Eurozone: external sector gets a helping hand from domestic demand....

- US import market is growing nicely, which, together with the accumulated weakness in the effective exchange rate since the beginning of 2014, continues to lend support to the recovery.

- On the domestic side it is encouraging to see that consumer credit is finally start to grow. Another positive is the continued improvement in car sales. Could it be that we now witness the first signs of a real comeback for consumer?

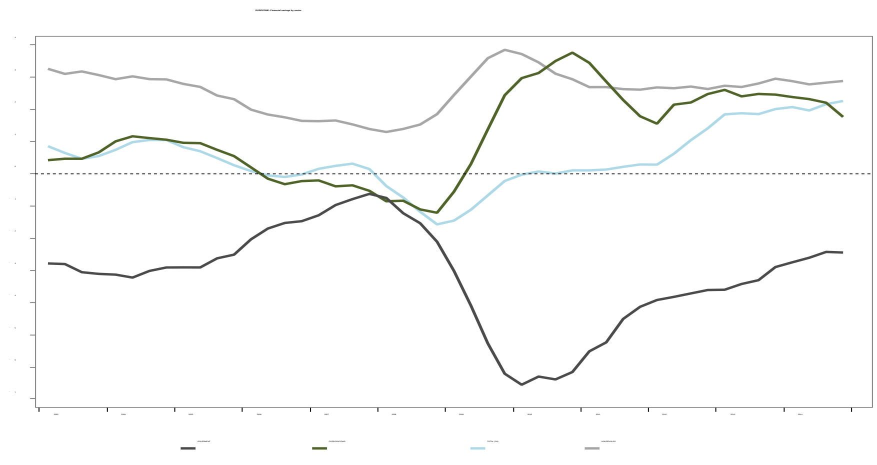


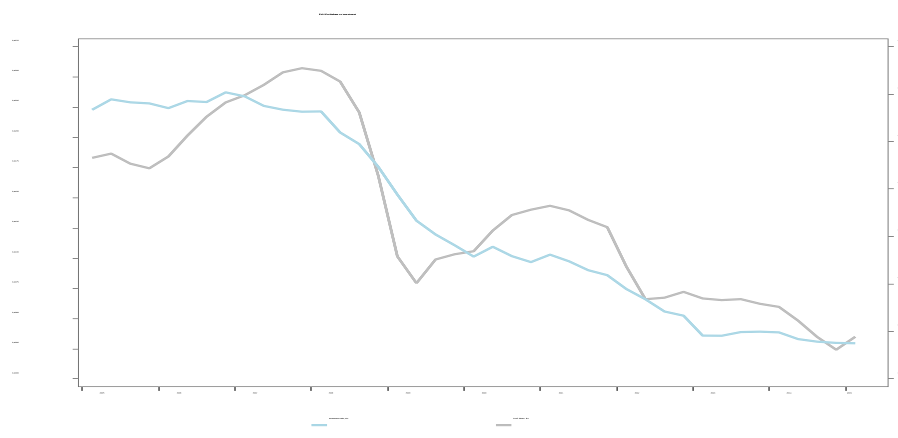




...but Eurozone could do a lot better with a more sensible macro policy

- Private sector continues to accumulate big cash surplus, i.e. spending considerable less than income, showing little confidence in the future.
- If the private sector were to revert to a normal spending pattern, we estimate activity in the Eurozone would be c3% higher than today, resulting in a strong persistent recovery.
- Unfortunately this is unlikely to happen as long as fiscal policy undermines confidence, leaving the private sector in a risk-averse mood.
- So, until policymakers change their minds, the growth outlook is likely to remain weak.





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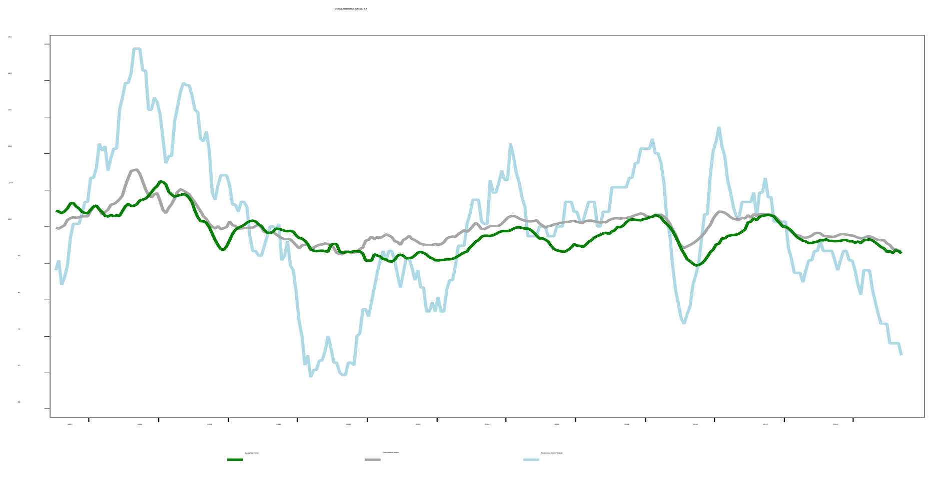
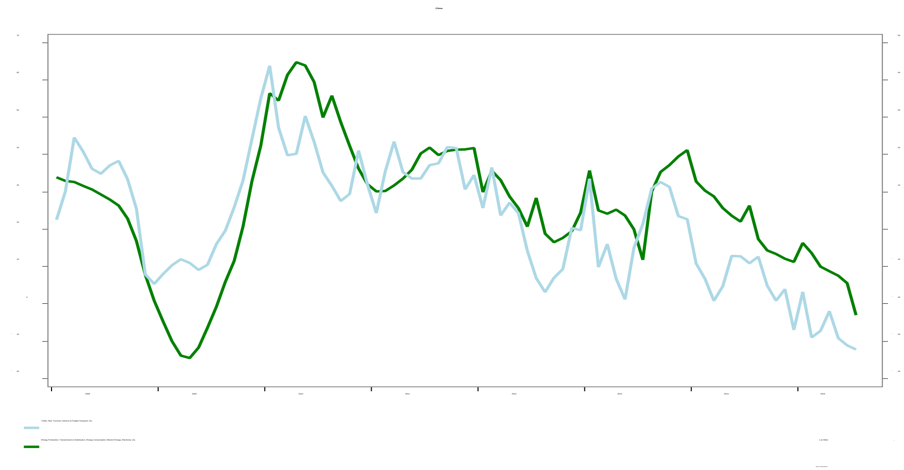
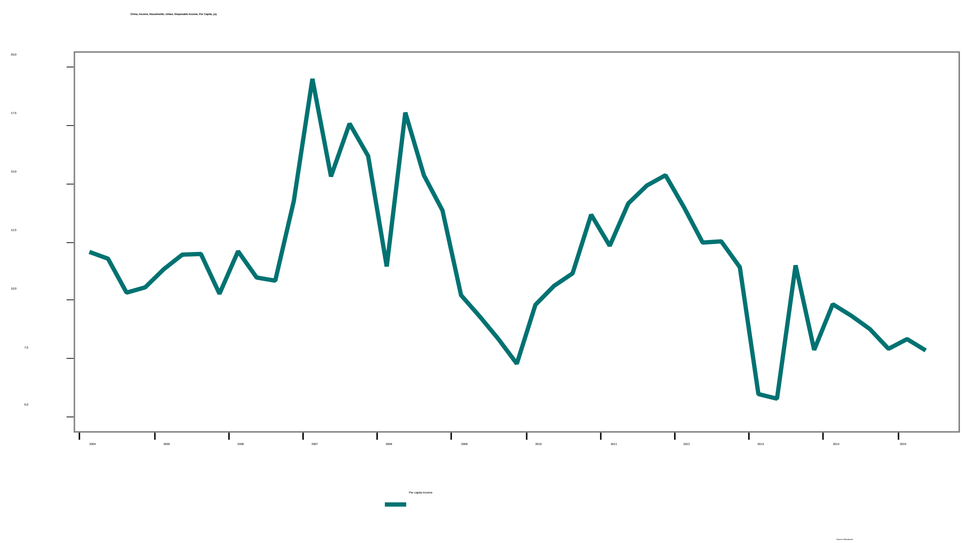
China: reforms in second place as policymakers focus on reviving growth momentum



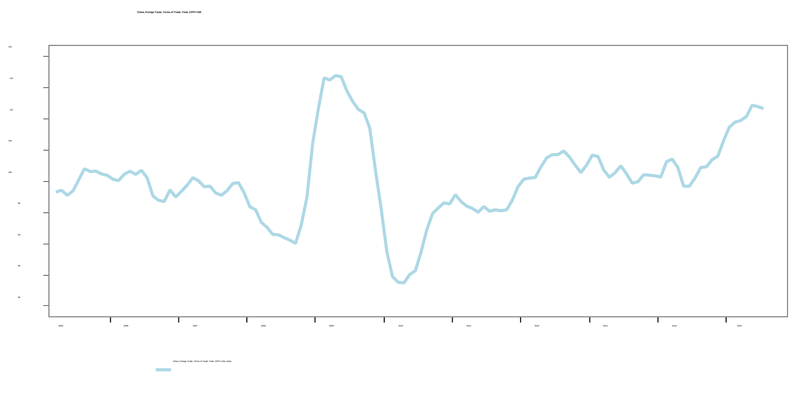




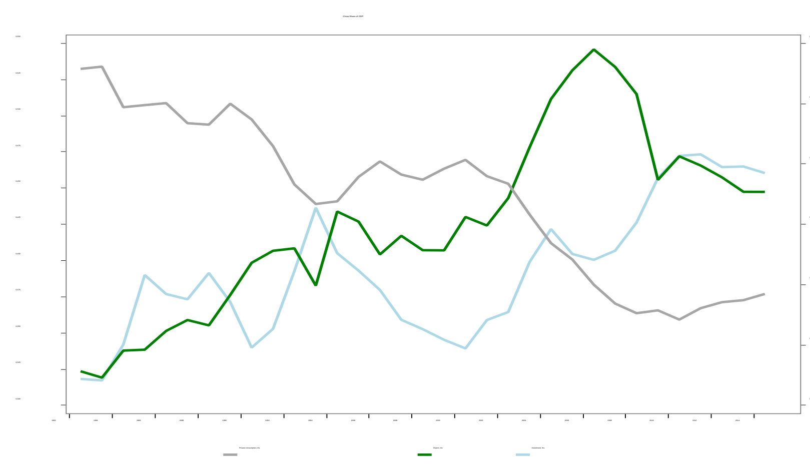
China: medium-term outlook – the big question is how to rebalance without major setbacks

Too dependent on exports and investments – weak DM and strong currency not that good for the economy.

- Problem: overdependence on investment and exports did not just happen – it is a consequence of the economic policy agenda.
- The rebalance from overdependence on investment is likely to remain a drag on the economy. A sustainable investment ratio should be c30% of GDP. To get there within 5–7 years implies growth in investment would lag behind GDP growth by c4–5%-points.



- This suggests a high risk of a hard landing and further downside risk in commodity prices.



So what policy tools does China have to play with?

- Nearly 40% of GDP in foreign reserves.
- Monetary policy support from lower rates, cutting reserve requirement for banks, bond buying, direct lending, and a weaker currency.
- Fiscal spending on a greater scale – on infrastructure and social reforms.
- Risk of credit crunch: total debt at c220% of GDP is manageable. But the risk stems from the concentration of debt, as 140% is in the corporate sector.

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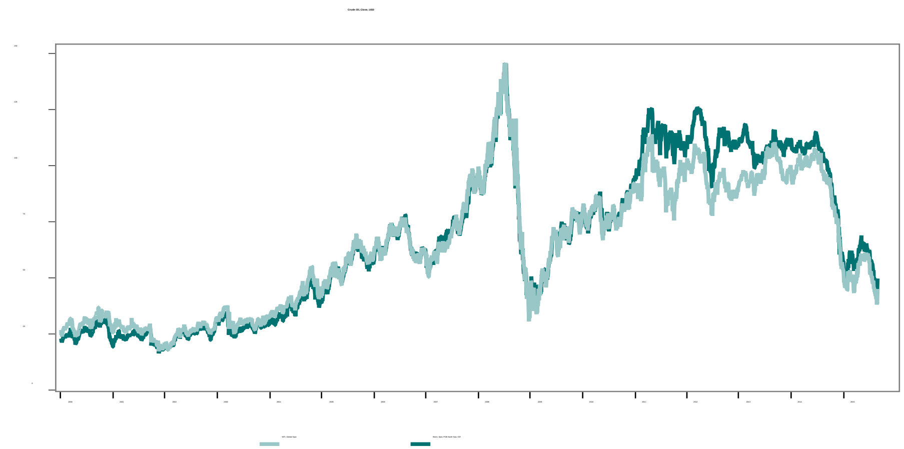
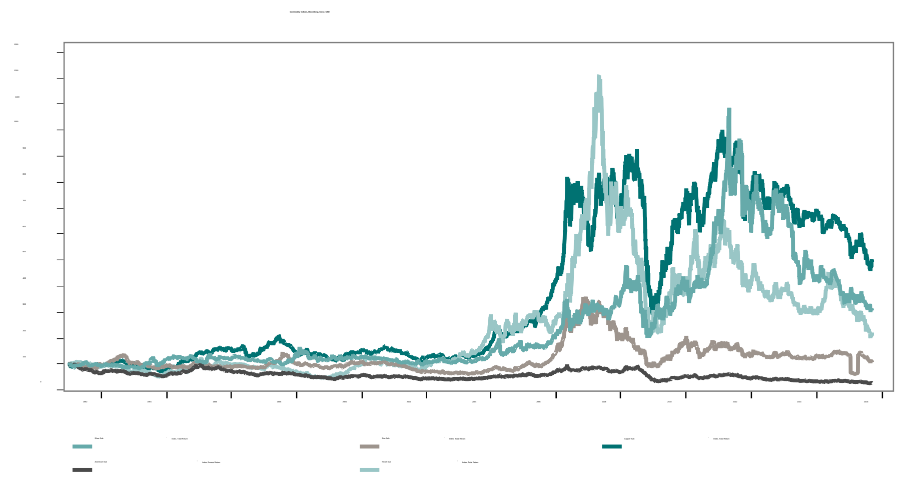
Commodity & energy prices in the wake of a weaker China: oil price back up, but the rest suffering from weak investment cycle





- We expect the oil price to be back to USD65/b in 2016e as the supply situation starts to normalize.
- Upside is capped by falling production costs, US spare capacity in the form of available rigs, and OPEC's market share strategy.
- The low price has boosted demand in 2015, but we expect this to fade in 2016 as the price rises as supply starts to normalize.
- Other commodities are still having a hard time as China's investment cycle continues to level off as the economy slowly transforms. In addition, the supply side situation looks set to continue to hurt commodity prices in 2016e.

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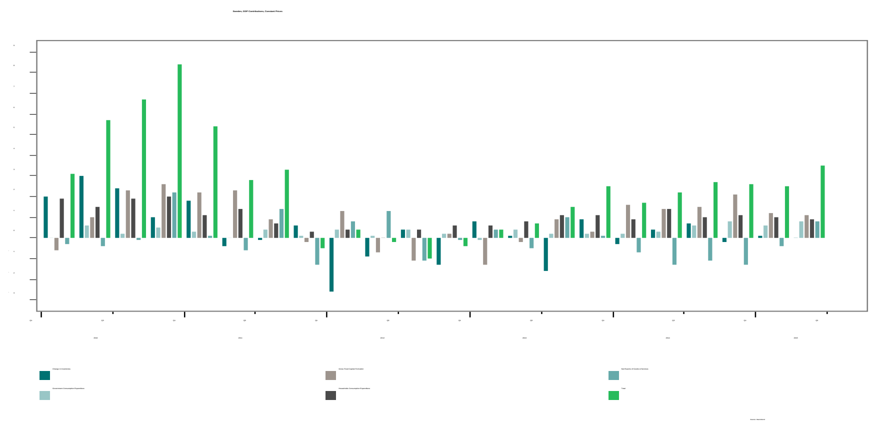
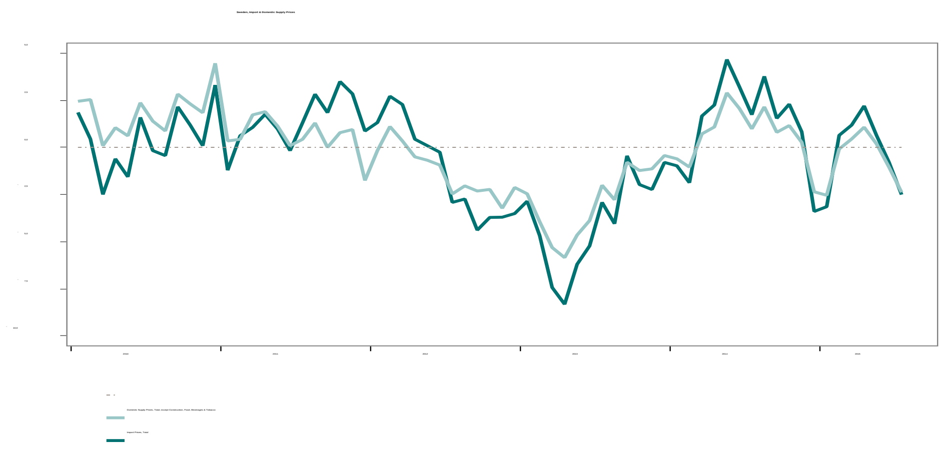
Sweden: cyclical rebound without with strong legs raises a question…

- After a long period of weak exports, we now see stronger momentum in exports and investment.
- Investment also gets a boost from housing. Despite this, new housing still lags behind population growth. This, and the absence of stricter amortization rules, looks set to keep house prices rising for the foreseeable future.
- Private consumption still an engine of growth as low rates and continued asset price inflation keep the household sector in a good mood.
- The public sector does not add much to growth as the government keeps a lid on the budget deficit.
- All in all, ***we expect a cyclical peak next year and thereafter growth to settle down at c2%***, which raises questions about whether growth is sufficient to keep inflation at the Riksbank's target.





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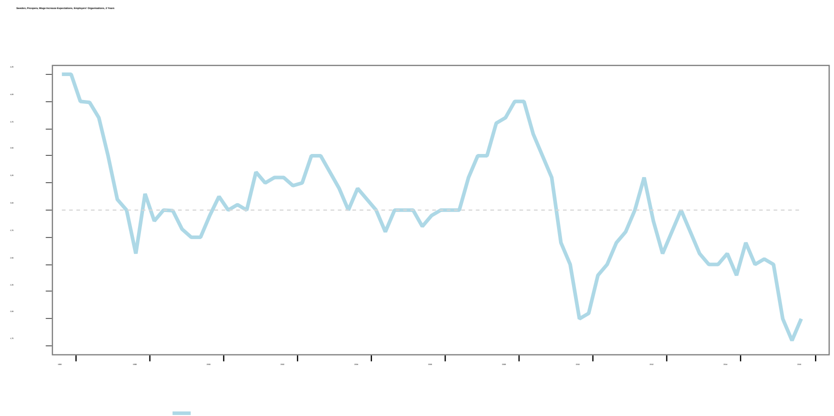
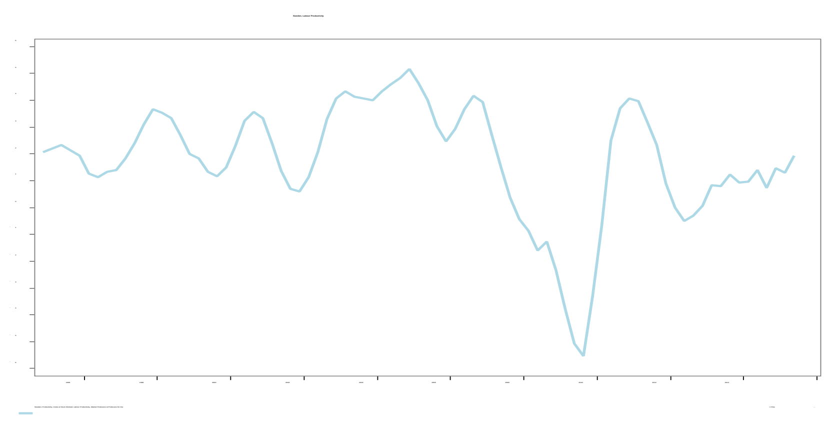
...about the Riksbank’s ability to create a sustainable lift in domestic inflation...

- Employers organizations' wage expectations for the next two years are well below what is consistent with long-term inflation of 2%. As about two thirds of inflation is generated by underlying wage cost, a result in line with current wage expectations would be a problem for the Riksbank.

- If wages do not grow fast enough, one could always hope that productivity falls short of expectations. But with current growth about 2% and a cyclical recovery on the horizon, this is unlikely to be the case in our opinion.

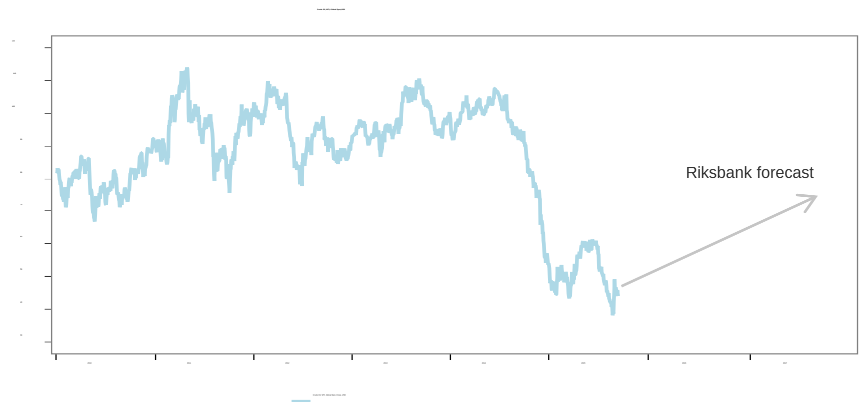
- All this points – from a Riksbank point of view – to a disturbingly weak domestic inflation picture and a need to import inflation to reach the target.

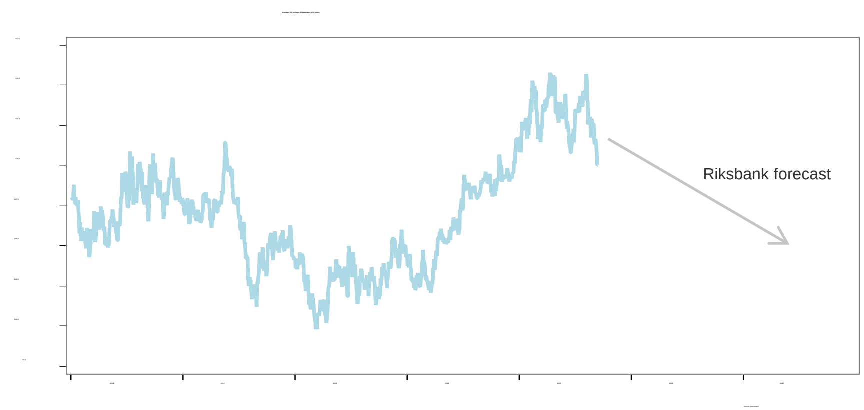




...or will the only rescue be a weak currency?

- The outlook for imported inflation depends primarily on non-durable consumption goods and the impact of the SEK.
- For oil the recent fall is not in line with the Riksbank forecast of a continued rise to USD70 by 2017. However, given the high volatility, this might still happen. Our view of the oil price is similar to the Riksbank's forecast.
- The most likely saviour is a weak SEK. As the Riksbank expects a near-8% strengthening of the KIX index by 2017 and still to get inflation back to 2%, a prolonged period of weakness could compensate for weak domestic inflation as importers finally raise prices.





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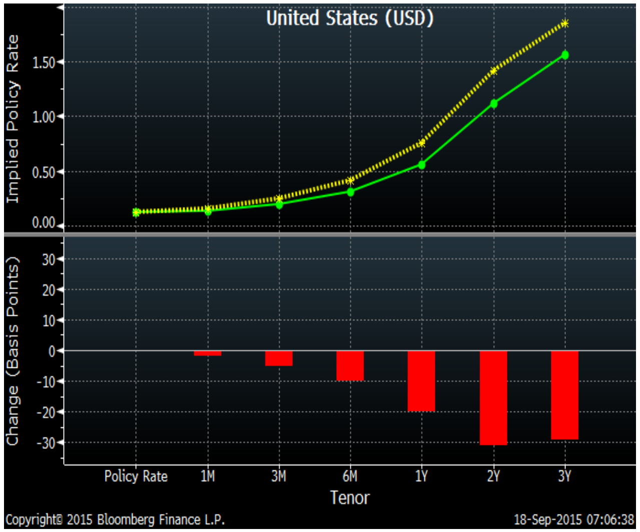
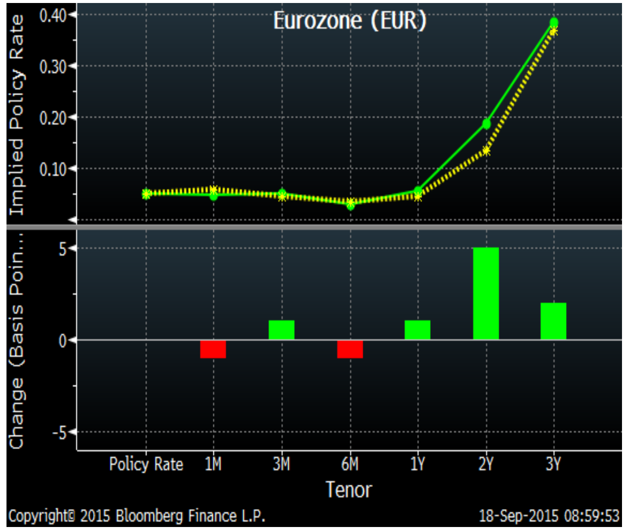
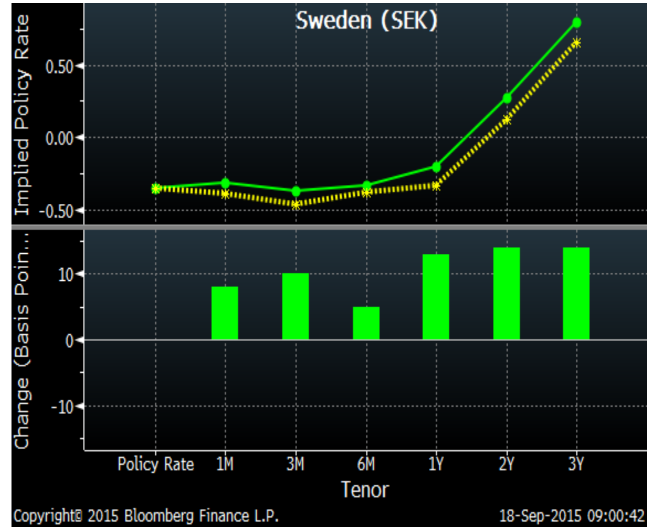
Monetary policy: central banks' short-term outlook well priced. But how much can it deliver?

***Expected central bank action compared the 10 of August when global worries resurfaced in the wake of China devaluation*.**







- Inline with our expectation Fed delivered a dovish statement and pushed hike further out in time. The timing will be decided by the international development. However, the big question remains the amount of tightening Fed can deliver in a world starved on growth. With a cyclical recovery we expect the market to keep current pricing. But, the US economy is still sensitive to a stronger USD and dependent on credit-driven consumer demand to sustain strong growth, hence we think that the 2-3 year segment still offers value.

- ECB: Given the policy set-up in the Eurozone with weak private sector demand and no sign of fiscal stimulus, in our view the Eurozone needs a weak currency. Current market expectations of no action for at least two years looks reasonable to us.

- Riksbank: Focus remains on inflation and the Riksbank is grappling with falling commodity prices and slow wage drift. With the upcoming wage negotiations and the ECB on the dovish side, we believe rate hikes will come more slowly than current pricing indicates.

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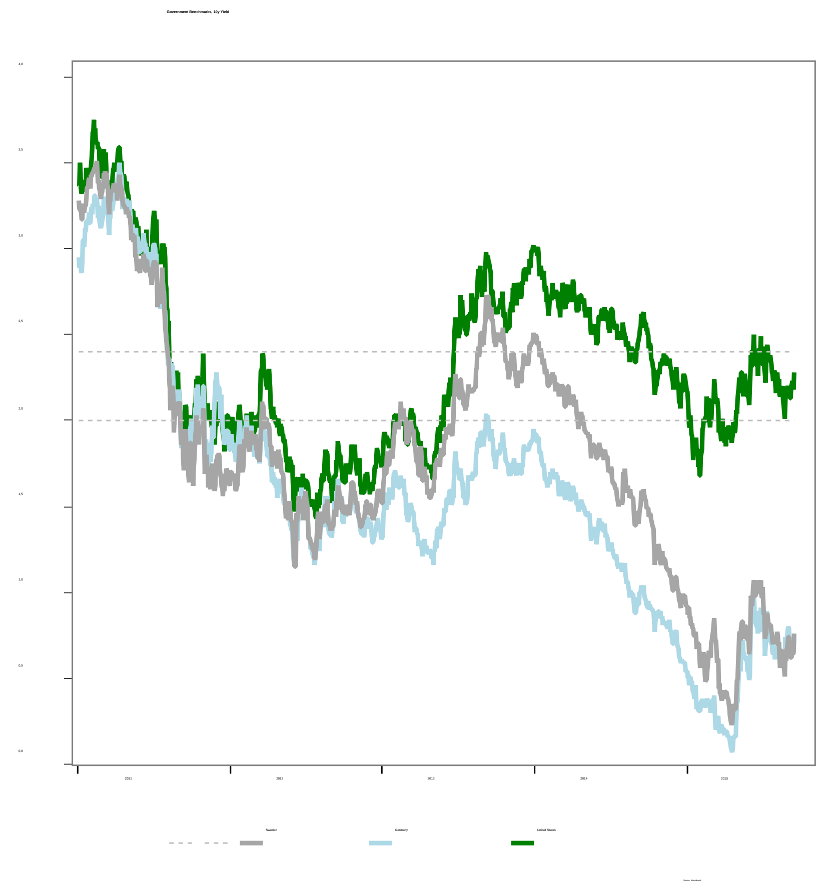
Bond market: dovish central banks and low growth expectations keep yields down

- Recent growth worries have not affected the 10y US treasury yield too much. We see no value below 2% and expect the trading range of 2.1–2.5% to hold as the market pushes the first Fed hike to the December meeting.

- Little confidence for the Riksbank ability to rise inflation calls for the need of a weak SEK – we expect that the Swedish bond market will continue to follow Germany and particularly the action from the ECB.

- Near-term trigger for the Swedish bond market continues to be focused around the SEK development, short term inflation figures and the upcoming wage negotiations as all these factors remains troublesome for the Riksbank:s current inflation forecast.



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Credit quality outlook: fairly stable with low default rate, risks linked to M&A

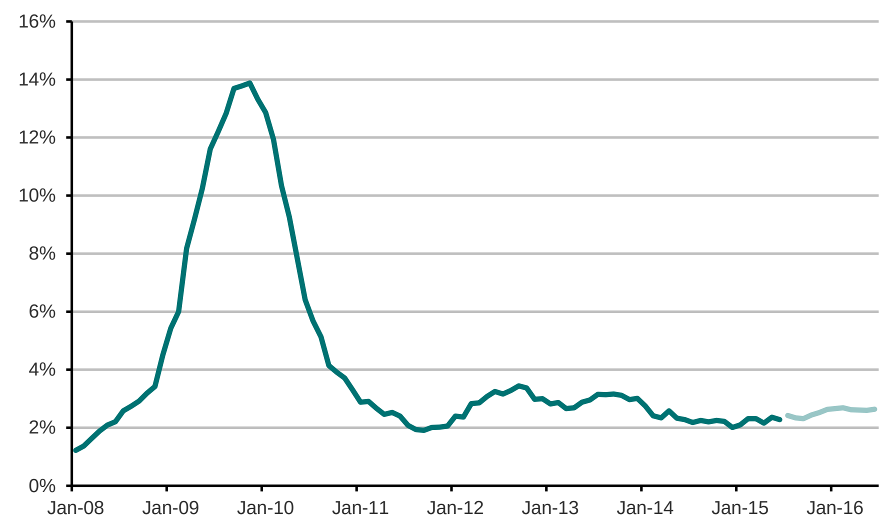
We expect general credit quality for European corporates to be fairly stable near-term:

- A gradually improving macroeconomic outlook in Europe, with emerging markets being the main drag.
- Corporate credit quality has so far been helped by tight cost control and favourable FX rates.
- Main risks are tied to increasing M&A activity, albeit at significantly lower levels than the US, where the corporate credit quality outlook is weaker due to more aggressive financial policy, the USD appreciation, and looming rate hikes.

Near-term default outlook remains favourable and stable:

- Lowest default rate since the financial crisis for European corporates.
- Helped by the macro environment and the accommodative ECB policy flooding the market with liquidity.
- We expect aggregated default rates to remain benign, and below 3% near-term.
- The divergence between sectors is likely to increase, with commodity and energy-related companies the most exposed.

Moody's global speculative grade default rate and forecasts



Sources: Moody's

Returns – fairly muted but well compensated for by credit risk component

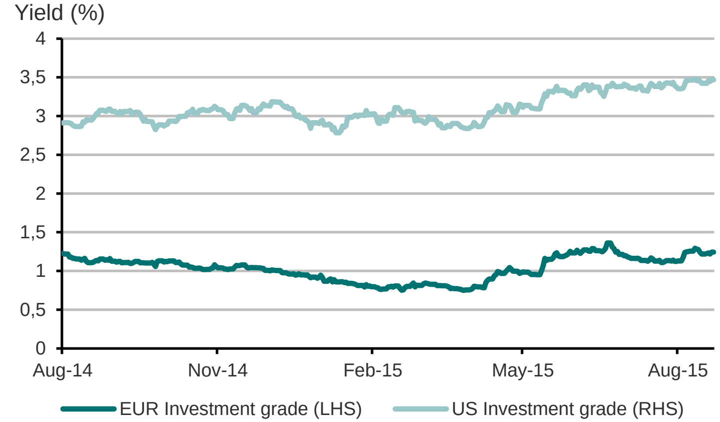
Recent market volatility could be an attractive entry point

- Generally well compensated for by the assumed credit risk.
- Volatile market conditions have raised credit spreads, while credit fundamentals and default rates are broadly unchanged.

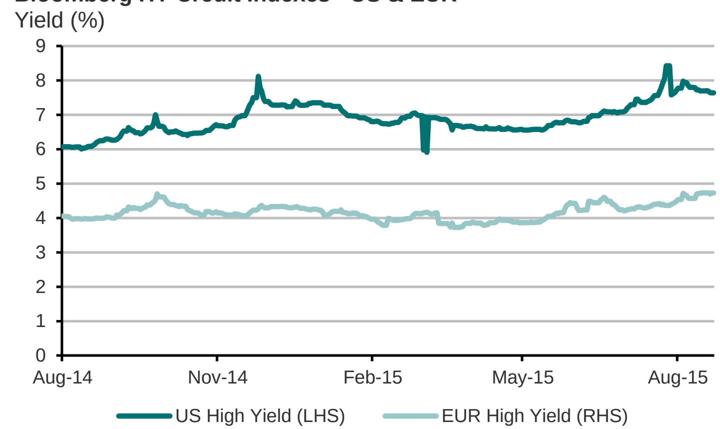
Return levels are still fairly muted but we like EUR HY

- Yields in the European IG space are seen just north of 1%, with similar return levels expected in the SEK space.
- Likely to push investors into the higher-yielding credits.
- ***We expect returns in the EUR-denominated high-yield space to be in the region of 5% in the next year***, with slightly lower returns for the SEK space given slightly lower credit spreads and assumptions of continued negative 3-month Stibor.
- Returns in the USD market are highly dependent on the Fed's policy and timing of the first rate hike.

Bloomberg IG Credit Indexes - US & EUR



Bloomberg HY Credit Indexes - US & EUR



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Equity market outlook

Modest growth and high valuation – not sounding like a great party

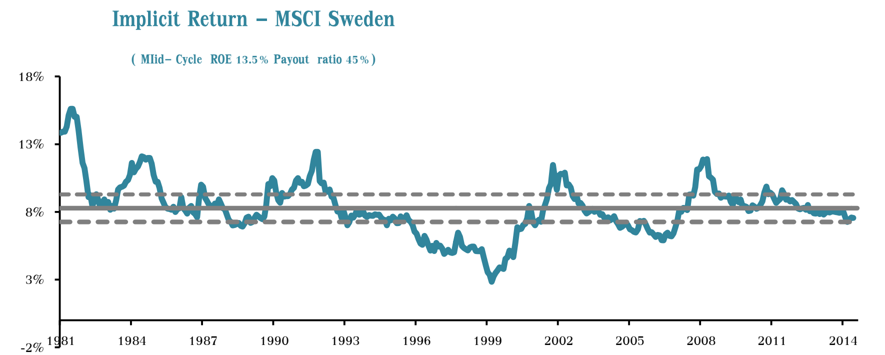
MSCI Sweden: FX is waning and next year and we need growth, or persistent low rates

- Valuations remain above historical averages, but Sweden does not look particularly pricey compared with other markets. Looking ahead: despite recent turmoil it is very unusual to see persistent drop in valuations without a big dive in profitability. We do not expect this to happen as the macro outlook – although uninspiring – looks stable.

- **Buy and hold: valuations and expected returns:** At current valuations, we believe the market is priced for yearly returns of 7.5% based on an historical mid-cycle ROE, still offering a sizeable risk premium.

- **Our 12-month view:** Looking into next year, we expect weak profit growth to lower the ROE by over 1%-point to 14.0% (equivalent to a 12-month forward P/E of 14.7x). This is still above the historical average and implies a 'fair value' at P/B of 2.3x under normal RRR assumption.
  - Hence, the fundamentals support a 12-month total return in the region of 8.5%.

- **All in all, after recent sell off due to global growth worries we believe the equity market offers value, especially in a current low-yield environment.**



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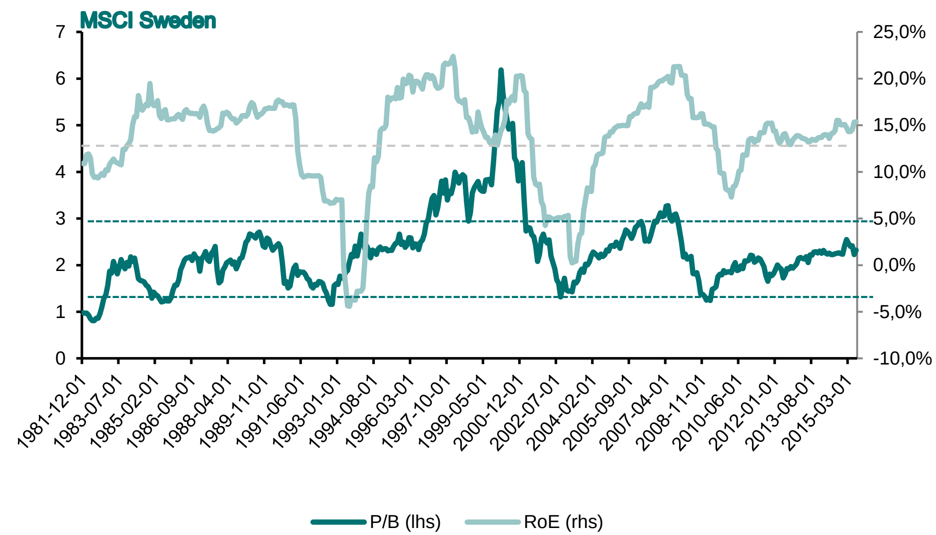

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