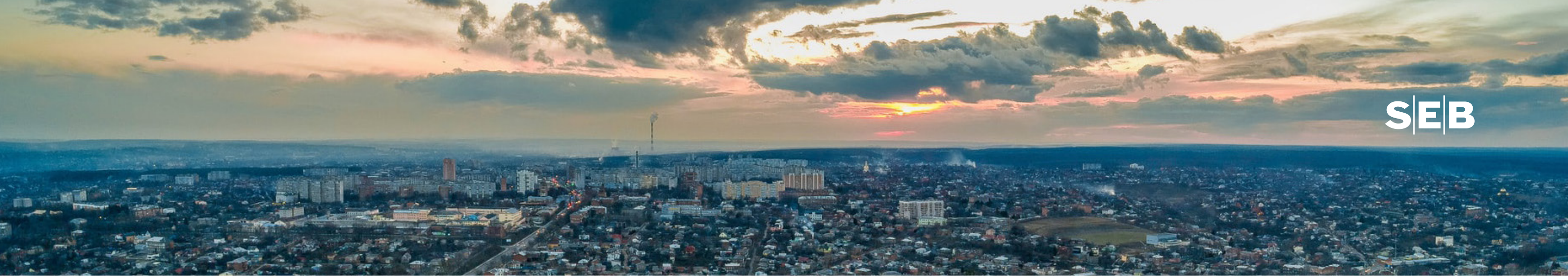


Scenarios for economies and markets

The war in Ukraine is continuing and deepening. The lives of innocent people are being lost or shattered, and our thoughts go out to all those who have been touched by this tragedy. Yet our task as financial advisors is to try to assess the impact of the war on economies and markets, and to describe how it may affect our customers' investments.

So far the war has lasted for a few weeks. According to reports, there is a clear risk that it will go on for another while. In addition to human suffering, this will also have economic consequences, due to acts of war themselves and to the sanctions that the war has triggered, but also due to the way consumers and companies react, along with investors. The future impact on economies and markets will depend on what happens with all of the above, especially the war and the sanctions. However, we are beginning to discern several different possible scenarios, which we would like to describe here. We also want to present our ideas on what investments to consider in these various scenarios. Despite unusually great uncertainty, there are some things that appear more or less probable.

The energy market in Europe, which was stressed even before the Ukraine war, will come under further pressure. Most people are well aware that we are seeing even higher prices for oil – and, above all, natural gas – and understand their impact in the form of higher prices for vehicle fuels and electricity, but also for other goods. This is also one of the great economic risks of the war. As we know, Europe's energy supply is largely dependent on deliveries from the affected region. If these deliveries are throttled by sanctions or damaged infrastructure, there is an obvious risk that energy prices will soar higher. This could have major consequences for economic growth in Europe, but in the long run also globally. Offsetting this is that both sides are dependent on a functioning energy supply system, but disruptions due to the war and sanctions – plus the fact that the transition to renewable energy sources has tightened energy supply – increase the likelihood that we will have to live with higher energy prices for a long period.

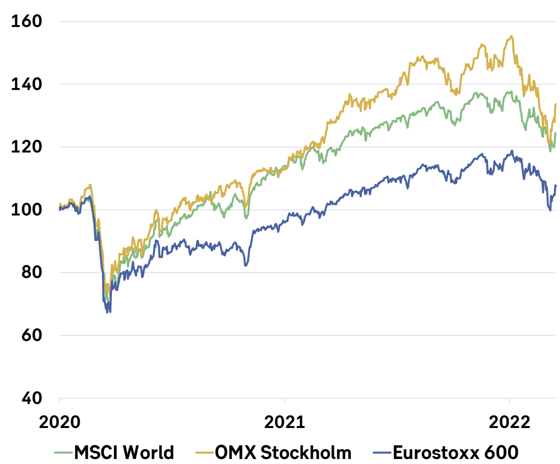
Worrisome inflation

Even before the war, we saw global inflation gradually rise to far higher levels than forecasters had predicted last autumn. What is happening now will add further upward inflation pressure – not only due to rising energy prices, but also because such product categories as metals, fertilisers, grains and other foods will be affected. Higher inflation is worrisome from two perspectives. It erodes consumer purchasing power, which risks hurting demand in the economy. It also puts pressure on central banks to raise their key interest rates faster than they had previously communicated, which in turn may inhibit growth.

This situation is undeniably worrisome, and the risks have increased. But there are several counterforces. Before the Ukraine war broke out, most observers – including us – expected relatively healthy economic growth this year. Because of the post-pandemic recovery, we expected global real GDP growth of around 4 per cent this year. For Europe, which is of course one of the most heavily affected major regions, we expected growth of 4 per cent. This was well above the historical average, so even if these forecasts must now be greatly lowered, growth may still be relatively good, since there is a "buffer" to draw from. Other positive factors are that both households and businesses have maintained relatively high savings ratios and thus have strong balance sheets. The effects of the war are also likely to be offset by various types of fiscal stimulus, for example subsidies or tax cuts to soften the impact of price upturns. We are also likely to see increasing capital spending, especially aimed at accelerating the transition to more renewable energy sources. In China the government's ambition to maintain growth is clear, and recent economic statistics are moving in a positive direction. Assuming that the spread of COVID-19 does not halt this trend, China may contribute to positive global growth.

But overall, most indications are that the inflation forecasts that were made before the outbreak of the Ukraine war must be raised, while growth forecasts will need to be lowered. The difficult question is how large these revisions will have to be.

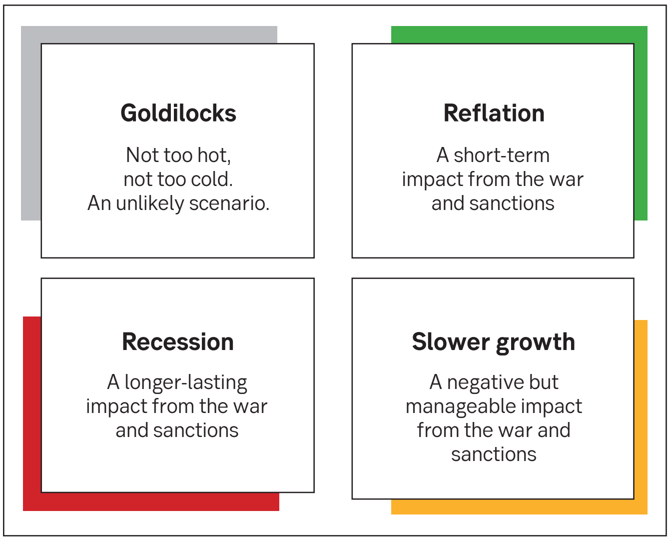
Stock market performance since January 1, 2020



So far in 2022 most stock markets have lost ground, following last year's big gains. Equities in Stockholm were among the winners in 2021 but are among this year's losers. Meanwhile share prices elsewhere in Europe have lagged behind the MSCI World Index for a long time. Source: Bloomberg

As usual in times like these, financial markets have reacted quickly to the new conditions. The recent stock market decline shows that investors are already expecting more headwinds from higher inflation and slower growth. This is also evident in the positioning they have indicated – in the form of outflows from risk assets such as equities and corporate loans. Investors have thus discounted worse conditions, at least in part. It is too early to say whether this is enough, too much or too little. It will depend on events related to the war, sanctions, commodity prices etc. Below are three different scenarios: one based on the current picture and the developments we believe markets have discounted, as well as a more positive scenario and a more negative one.

Scenarios – what may happen?



The illustration shows four different scenarios: goldilocks, reflation, recession and reflation. Below we explain in greater detail what slower growth, recession and reflation mean – and what impact each of these scenarios may have on economies, markets and investments.

Slower growth

- Stabilising inflation
- Stabilising energy prices
- Weaker, but positive economic growth
- Volatile markets

Slower growth: A negative but manageable impact
Unfortunately there is little indication that the Ukraine war will end soon. But its tragic humanitarian effects, increasingly negative public support and rising costs still point to the possibility that some form of negotiated solution can be achieved within a reasonable time. What will (cynically enough) be crucial for global growth and financial markets is whether or not energy and other commodity supplies to Europe and the world are further affected. If supplies are not further affected, energy prices may stabilise or fall. But due to market imbalances, they are likely to remain relatively high. Roughly the same thing is true of inflation, which we forecast will start to fall back but remain above central bank targets for some time to come. In this scenario, growth forecasts will need to be adjusted downward, but growth may remain relatively healthy. Forecasts of corporate earnings this year will also need to be adjusted. Already rather low expectations of global earnings growth just above 5 per cent are being reduced to 0 per cent this year, while next year corporate earnings may revert to normal growth of 5-10 per cent. In this scenario, we believe that central banks will go ahead with their rate-hiking plans and that long-term bond yields will increase slightly from today's low levels.

From a stock market perspective, this scenario is largely reminiscent of the picture we painted before the war broke out, since the market had already discounted weaker growth. We believe there may be potential for minor stock market upturns from current levels but that we would see a lot of volatility and no clear trends in terms of what type of shares and what style (growth, value, defensive, etc.) would benefit. This suggests a broad portfolio, with good risk diversification and with equities accounting for close to or just above the desired or "normal" percentage of all holdings.

Recession

- Rising inflation
- Rising energy prices
- Negative growth
- Focus on risk minimisation

Recession: Things get worse before they get better
As we have noted, the risks to economic growth have increased. The clearest and most direct effect would occur via energy prices. If supplies are threatened, due to sanctions or warfare, the market would become even more stressed and prices would rise. This would add fuel to already troublingly high consumption and further reduce the room for consumption. It would also hurt other parts of the economy, such as energy-intensive manufacturing and food production. A recession in Europe would be a definite possibility. Nor could a global recession be ruled out, especially if central banks raise interest rates to curb inflation and/or if China's problems escalate – hampering both supply and demand.

In a recession scenario, we can probably count on strong stimulus measures by political leaders around the world. Of course this would ease the impact on the economy, but stimulus measures primarily sustain demand and are less helpful if the supply side is being disrupted via the energy sector. However, history suggests that recessions are relatively brief. The fact that we are entering this situation with a recovering economy and that households and business have strong balance sheets suggests the same thing.

A recession has not been priced into today's share valuations. Weak economic growth would probably lead to downward adjustments in earnings forecasts, putting pressure on share prices. It is also reasonable to expect that lower earnings would lead to lower valuations, which might accelerate a stock market decline. When recession risks begin to dominate, the impact on stock markets is often rapid and brutal. It may be hard to adjust the portfolio in time, but during this process, risk minimisation is required – a down-weighting of equities in portfolios, a focus on defensive sectors such as pharmaceuticals and this time around also on energy companies, which would become relative winners when energy prices are driving developments. Long-term government bonds benefit from falling interest rates, but low rates limit their potential.

Reflation

- Falling inflation
- Falling energy prices
- Faster economic growth
- Risk assets benefit

Reflation: Danger is past, time to look ahead

Unfortunately the probability of a brief conflict is decreasing over time. But the opportunity is there, and perhaps the cost in human lives, public support and the economy may persuade Putin to find a way to end the war, in exchange for some face-saving gains in the negotiations. This would soon enable us to look ahead to spring, not only meteorologically but also economically. Energy prices would likely fall back from their highest levels – partly driven by the launch of large investments in renewable energy, which in themselves would contribute to growth. Earlier forecasts indicated that inflation would peak this spring, a scenario that may still prove correct. This would reduce pressure on central banks to hike interest rates and help to ensure that long-term bond yields do not rise significantly. Another positive factor is the household savings surplus; with the pandemic behind us, at least in the West, pent-up consumption needs might be transformed into action. Although developments in China are worrisome, political leaders there have indicated that they prioritise stability, including in financial markets. They have set an ambitious growth target, which may be justified by the desire to ensure a bright economic outlook ahead of next autumn's Communist party elections.

In a reflation scenario, corporate earnings forecasts would be adjusted higher. Since stock market valuations have fallen, this would make room for solid upturns. Assuming a strong economy, these upturns would be led by cyclical sectors such as manufacturing and commodities, as well as banks. Rising interest rates and yields would create headwinds for some fixed income investments. Among such investments, those with higher credit risk – high yield bonds – would benefit from narrowing credit spreads.

By way of conclusion

In addition to the usual economic risks, the situation is being made worse by the tragic Ukraine war and its effects. By presenting the above scenarios, we wish to indicate possible trends as future events unfold. The actual outcome will probably be a combination of the events described, depending on what happens and how political leaders, businesses, consumers and investors react.

The financial market picture is undoubtedly worrisome, and risks have increased. Near-term developments are uncertain and risky, yet we still believe that over time, risky assets such as equities will generate good returns. A sound strategy may be to contact your advisor and review your portfolio to ensure that your investments and risks are as desired.