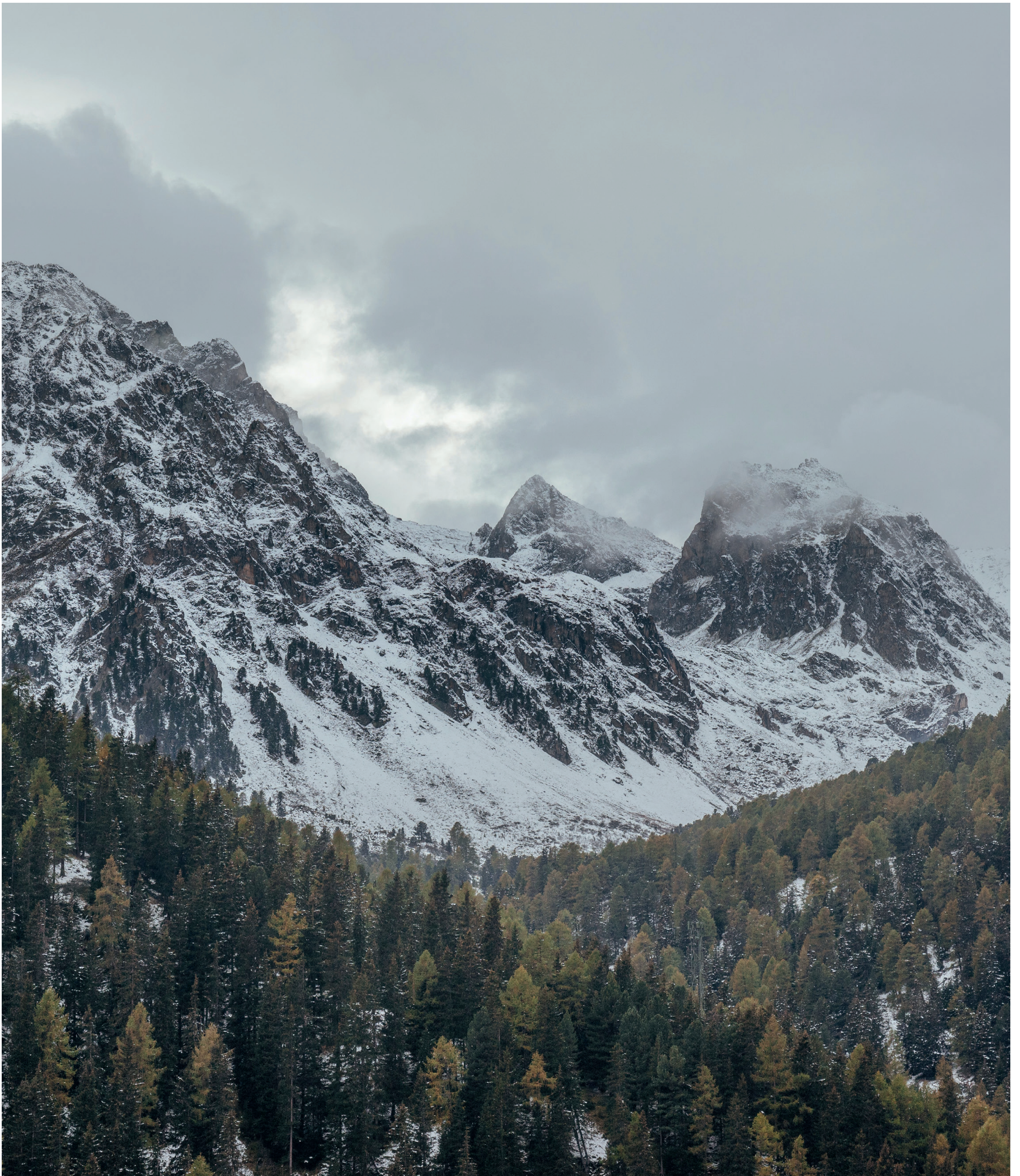

Investment Outlook

Worries fading as double turnaround takes shape

November 2023

SEB

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Introduction

It finally looks as if long-term government bond yields have stopped rising. A continued decline in inflation rates indicates that central banks may start cutting key interest rates around mid-2024. As a result, investors' risk aversion is starting to ease. But we must also get through a late-cyclical phase that is forecast as a soft landing in the global economy. Of course, there is a risk that the slowdown will be worse than expected, since the effects of sharp rate hikes may hit us harder than we have anticipated. But our main thesis is that the slump will be fairly shallow, and as early as the second half of 2024 we believe that activity can gradually accelerate again. The key to stock market performance going forward probably lies in how investors choose to relate to the "double turnaround" we describe here, with key interest rates falling and growth rebounding after a soft landing. As this picture becomes increasingly clear, the likelihood of a more positive undertone for risk assets increases. It cannot be ruled out that this will be discounted in the near future, but we foresee that temporary (?) disruptions in performance may create setbacks for some time to come.

Investors remain rather wary and cautious in their risk-taking. Equity valuations are at levels in line with the pre-pandemic period. The exception is the US stock market – driven higher by strong growth company giants. The pricing of these favourites is now clearly higher than before the pandemic. As a rule, investors are often overweight in fixed income instruments when they are being traded at yields we have not experienced since before the global financial crisis. If they provide good returns due to falling key rates and if the economy stabilises, some of this money will gradually move into other asset classes such as equities.

Given this picture, we advocate a neutral risk level, since we foresee good opportunities in the medium term but potential problems in the short term. Our portfolios include a neutral proportion of equities, while we are overweight in fixed income investments vs alternative investments in the form of hedge funds.

This *Investment Outlook* includes two theme articles. The first deals with the unprecedented success of GLP-1 drugs, which are used to treat diabetes and obesity. This fast-growing market is currently dominated by Novo Nordisk and Eli Lilly, but more and more players are trying to break in. Studies are now also showing the good effects of GLP-1 drugs on cardiovascular diseases, which makes us wonder how big their potential is. Our second theme article focuses on the global energy system. Inflation, rising interest rates, wars and energy transition have all influenced the volatile developments of recent years. In Sweden, electricity prices skyrocketed but this upward pressure gradually eased. Read our analysis of the power market and how its future price dynamics may look.

Wishing you enjoyable reading,
Fredrik Öberg, Chief Investment Officer
Investment Strategy

Market view, risk exposure and allocation

It looks as if today's situation, with double braking mechanisms in the form of a cyclical slowdown and a continued fight against inflation accompanied by tight monetary policies, may possibly ease The latest statistics on inflation and economic activity in the US indicate a slowdown that supports the more dovish message being conveyed by the Federal Reserve. This has led to falling bond yields and rising risk appetite. We are still in a late-cyclical phase, with a predicted soft landing ahead of us. This makes it more likely that government bond yields peaked this autumn and that positive returns for this asset class lie ahead. In this phase, risk appetite usually diminishes since earnings are squeezed and the percentage of credit events increases, but the situation becomes more balanced once key rate cuts and growth recovery take shape. In this environment, we believe that risk exposure around a neutral position is appropriate.

Risk exposure and allocation

During 2023, investors' risk appetite and preferences for various types of financial instruments have been dominated by central bank tightening, aimed at pushing down high inflation. Investors have also factored in the resilience of various geographical regions in the late-cyclical phase, the continuing geopolitical conflict in Russia and Ukraine and the "new" conflict that has unfortunately escalated around Israel. The overall situation has prompted investors to be cautious and not expose themselves to significant risks, since the current environment is generally synonymous with weakness in the corporate sector's ability to generate profits – alongside an increased percentage of credit events and defaults.

In spite of this, financial markets and the real economy have performed better so far than many had feared. The economy is slowing, but partly due to great resilience in the US it is holding up better than expected. Forecasts indicate some kind of soft landing. This must be regarded as surprising, since central banks have been forced to raise their key rates from ultra-low levels by up to 4-5 percentage points in a very short time span.

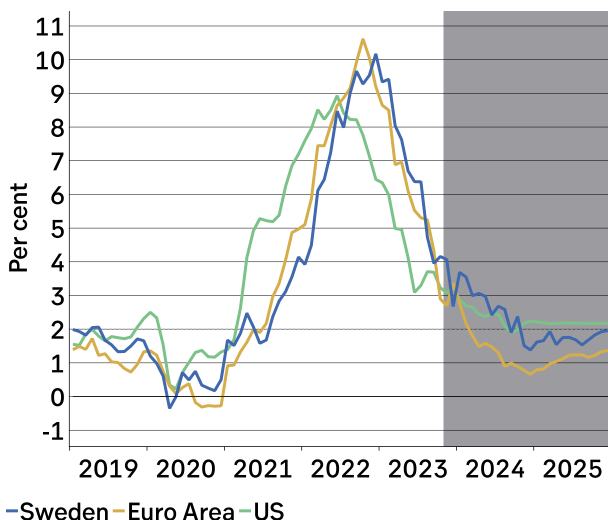
This is also taking place in a situation where public sector debt in many countries has reached high levels and both companies and individuals face much higher interest costs. But in Europe, there is now a clear deceleration in growth to levels near zero, with Germany as one of the weaker economies – one reason why Swedish GDP is expected to shrink both this year and in 2024; an extremely weak construction sector is also contributing to the downturn. The Chinese economy is not showing the acceleration many had expected, due to weak consumer demand and a shaky real estate sector. The stimulus measures that Beijing has launched so far have not been enough to boost growth. All in all, we expect the world economy to experience a soft landing, growing by around 3 per cent annually during 2023-2025 – a rather anaemic growth environment, where inflation is expected to continue falling towards central bank target levels.

BNP growth forecasts, %

Market	2023	Rev	2024	Rev	2025	Rev
World	3.0	0.2	2.8	0.1	3.2	0.0
United States	2.3	0.3	1.1	0.2	1.8	-0.2
China	5.2	0.0	4.6	-0.1	4.5	-0.3
Germany	-0.2	0.2	0.5	-0.3	2.0	0.1
United Kingdom	0.4	0.3	0.5	0.0	1.7	-0.1
Sweden	-1.0	0.2	-0.4	-0.5	2.5	0.0
OECD	1.6	0.2	1.2	0.0	2.0	-0.1
Euro area	0.5	-0.1	0.7	-0.1	2.0	0.0
Baltics	-0.7	-0.3	1.5	0.3	2.9	0.1
Emerging markets	4.1	0.1	4.0	0.0	4.1	0.0

The table shows forecasts and revisions for real year-on-year economic growth in per cent, in line with our main scenario – expressed in purchasing power parities (PPP). For a more detailed account of SEB's economic forecasts, see the "International overview" section, which is an excerpt from the issue of *Nordic Outlook* published on November 14, 2023.

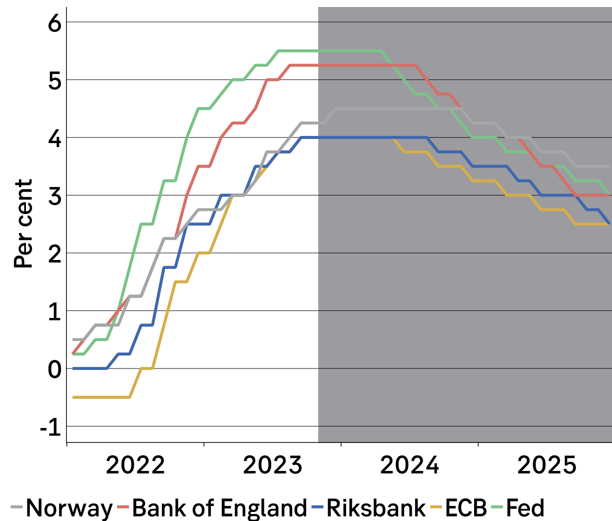
Forecasts show continued positive but falling inflation rates



Source: SEB Nordic Outlook

The chart shows actual inflation rates to date, supplemented by our forecasts in the grey portion to the right. We expect inflation to reach central bank targets by late 2024.

Central banks will reach a plateau before it is time to cut rates again



Source: SEB Nordic Outlook

The chart shows that we expect the first cuts around mid-2024.

The probability of conceivable outcomes and a more detailed picture of economic developments are presented in the "International overview" section, which is an excerpt from the *Nordic Outlook* published on November 14.

Among factors contributing to resilient American growth so far are the government's large fiscal stimulus measures. The corporate sector has managed to maintain reasonable overall margins, since consumer demand in particular has been sustained thanks to large savings buffers. In addition, earlier price hikes are being followed by falling input goods prices, which are offsetting wage and salary increases.

Of course, there are wide differences depending on what sector we study, but overall global corporate earnings during 2023 have been around zero. The manufacturing sector has lost speed and momentum, while financial services have benefited from positive and rising interest rates. Portions of the consumer goods and service sectors have also held up well, since there was pent-up demand after the COVID-19 pandemic, with both accumulated savings and a labour market that has so far proven more robust than usual as the economy slows.

Finally, the problems that have flared up in the US and European banking sectors, as well as weaknesses in China's real estate sector, have been dealt with through rapid responses by governments and central banks. As a result, broad downturns in segments of the capital market have not infected the banking sector and the functioning of the financial system. The stock and bond markets have also dealt with these "write-downs" without panicking.

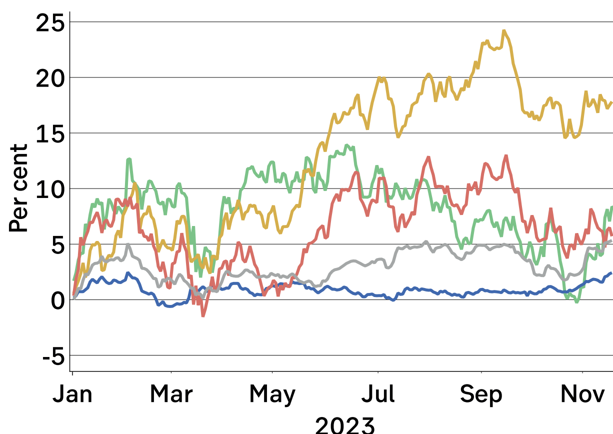
So far, 2023 has not been a brilliant year for investors. Volatility has been high, and capital has shifted towards market segments offering stability and strength. This means strong balance sheets, solid market positions and – in the fixed income world – short-term instruments, so as not to be penalised by rising yields.

For example, there has been extensive publicity about the "Magnificent Seven" – a cluster of successful growth companies with a primarily high-tech profile traded on US stock exchanges, which have developed into even clearer favourites among investors. Their successes have been richly rewarded by rising share prices, and they now make up a large percentage of both US and global stock market indices.

The combination of an economic slowdown, central banks that are slamming on the brakes and governments with strained balance sheets – which hampers fiscal counterforces – has made investors risk-averse. But so far, this situation peaked as early as the summer of 2022, which partly explains why a balanced portfolio has been able to show positive returns in 2023. Deteriorating conditions were discounted well in advance. Blunted risk appetite and reasonable valuations have been important motives behind our recommendation this year not to follow the investor community and create distinctly defensive portfolios. This would have been a costly decision. From a Swedish perspective, we have also enjoyed extra returns from global equities – measured in SEK – via a positive foreign exchange effect that arises when the krona weakens in relation to other currencies.

Recently, risk aversion has diminished, stock markets have recovered, and bond yields have fallen. This is because they had previously moved in the opposite direction. The Fed's rhetoric softened, and the market quickly discounted an improved future. It is possible that investors are already discounting the double turnaround we expect in 2024 in the form of falling key interest rates and gradually improving growth. However, we see risks of setbacks in the short term. While waiting for data that will give us the answer, we consider it wise to maintain a neutral position in our portfolios.

Global equities are this year's winners in our portfolios



Source: Bloomberg

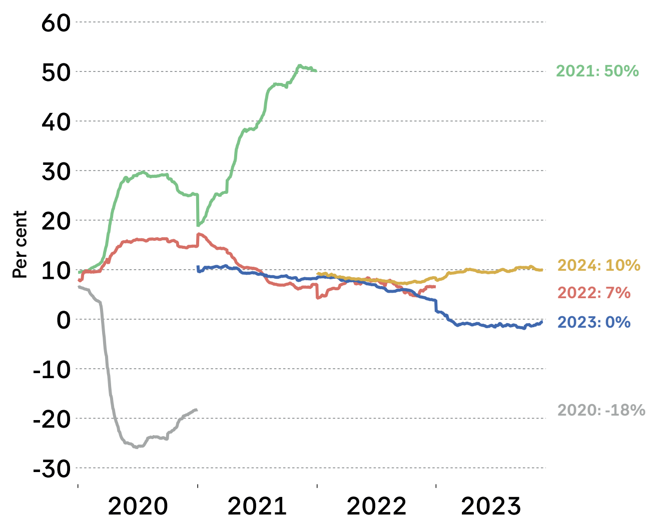
The chart shows the performance so far in 2023 of Swedish equities (SBX), the MSCI World Index and the MSCI Emerging Markets (EM) index in terms of Swedish kronor. It also shows the performance of Sweden's OMRX Bond fixed income index and a global high yield (HY) index hedged to Swedish kronor.

What should happen in capital markets in the soft-landing scenario?

Investors have steered their portfolios towards bonds with high credit quality, reducing the equity portion to a neutral or underweight position. Cash holdings have normalised after having been unusually high for a long period. In the stock market, stable sectors such as pharmaceutical companies and large growth companies have benefited, while cyclical sectors and interest-sensitive sectors are among those that investors have downweighted. In the Swedish stock market, the trend has been slightly different, with financials and industrials performing much better.

The above implies that investors have tried to respond to negative forces from both the economic slowdown and central bank interest rate hikes. The soft-landing forecast is based on the expectation that corporate earnings may be squeezed during the first half of 2024, then begin a recovery. Business analysts have a more positive view of the future. They expect earnings to climb by around 10 per cent in 2024. This seems overly optimistic. Downward adjustments are to be expected.

2024 global earnings forecasts for listed companies are too positive



Source: Bloomberg

The chart shows how corporate earnings forecasts, expressed as percentage changes for each calendar year, are revised over time. These estimates are for global stock markets as a whole and follow the allocation in the MSCI World index.

However, downward revisions to earnings forecasts are unlikely to come as a surprise to investors, most of whom have composed their portfolios in a way that indicates that they are worried about this.

The slowdown in economic activity and higher bond yields have already led to more credit events in the corporate sector during 2023 than in the previous year. During 2024, the level of credit events is expected to remain above the long-term average, ending up in the 4-5 per cent range. This is simply the expected effect of a shakier demand situation, combined with higher interest costs for the loans that companies are carrying – which in itself is consistent with the predicted soft landing.

Recently, we have seen indications of how the market may behave during 2024. The Fed's latest communication effort have signalled a less restrictive stance, causing government bond yields to fall while risk appetite and stock markets have moved in the opposite direction. The question is whether it is already time for investors to start raising the risk in their portfolios, or whether we should wait until we have gone through a period of further weakness due to the economic slowdown.

Positioning, or overall portfolio composition among professional investors, reflects a rather cautious approach. What about the valuations of various assets? Are their starting points attractive enough to overcome investor uncertainty about economic effects and central bank behaviour?

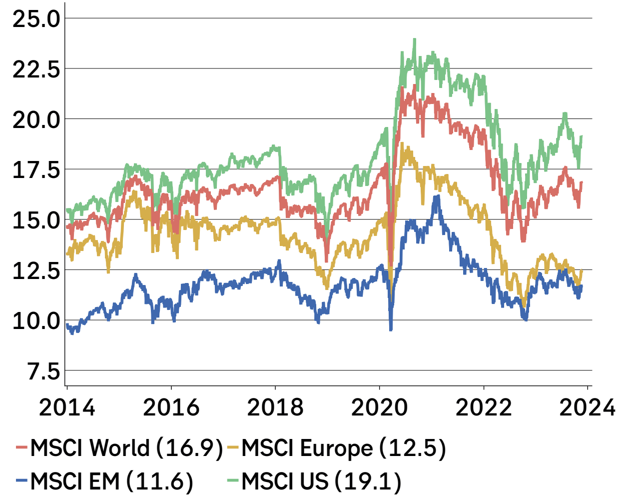
The difference between absolute and relative valuations

Market interest rates are dictated by central banks. Added to these are risk premiums or compensation for greater risk when moving from government- to corporate-issued bonds. Creditworthiness determines how much extra compensation the investor should receive on top of government bond yield. This compensation varies over time. Today, the interest rate premium is 4-5 percentage points in the high yield segment (greater risk) and 1.2-1.5 percentage points in the investment grade segment (less risk). These figures apply to the US and Europe, bringing the total current yield on high yield bonds in both regions to around 8.5 per cent. For the investment grade segment, it will be approximately 4.5 per cent in Europe and nearly 6 per cent in the US.

These are yields we recognise from the period before the global financial crisis and that have been conspicuously absent during the long period of stimulus measures that followed. We have thus experienced a kind of normalisation over the past year, since we do not expect central banks to cut their key interest rates to zero again. Our forecast is that they will stay at around 2-3 per cent. This indicates that investors can expect positive returns on fixed income instruments over the next couple of years.

As for stock market valuations, price-earnings (P/E) ratios – usually based on earnings forecasts for the coming 12-month period – have been adjusted to conform with the pre-pandemic period. However, the US market is enjoying a larger premium than before, and Europe a larger discount. This is partly due to the success story of major American growth companies. Not only have they delivered impressive earnings, but they enjoy higher relative valuations than before – though not as accentuated as during the pandemic period.

US share valuations have risen compared to other stock markets

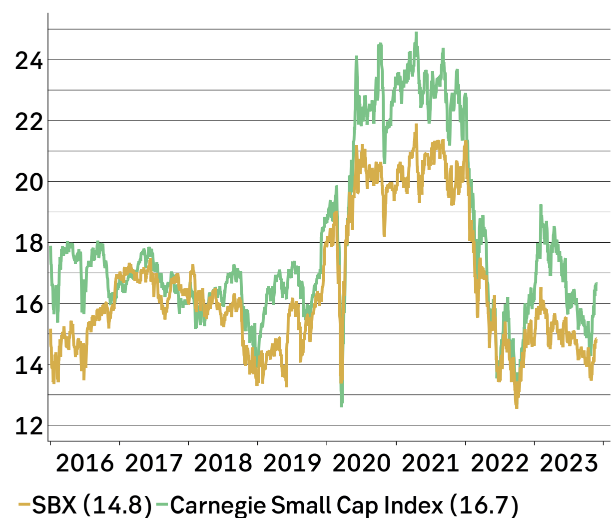


Source: Bloomberg

The chart shows valuations measured as share price divided by earnings, so-called price-earnings (P/E) ratios, based on 12- month forward-looking earnings forecasts. Stocks with high growth, stable earnings and good returns on equity are valued the highest. Defensive stocks are valued at or slightly above the average. Cyclical stocks have a clear discount to the average. Equities in Europe and emerging markets are valued lower than in the US, and this is a combination of style composition in the various regions but also regional pricing.

The Swedish stock market has also fluctuated significantly during 2023 in terms of overall P/E ratios. During the period of pandemic-based stimulus measures, unsustainable heights were reached. Today we are back at levels we recognise from the pre-pandemic period.

Swedish share valuations have fluctuated sharply



Source: Bloomberg

The chart shows valuations measured as share price divided by earnings, so-called price-earnings (P/E) ratios, based on 12-month forward-looking earnings forecasts. In Sweden, unlike in the US, the growth segment has been associated with small and medium-sized companies, which again have a premium to the large cap segment.

Turning finally to the relative valuations of stocks and bonds: when both asset classes have normalised, the risk premium for owning equities versus bonds will be clearly lower than during the zero interest rate period. This is one reason why investors have put a higher-than-usual proportion of their assets into the fixed income segment.

Potential outcomes around our main scenario

Despite all the current wars and misery in the world – and an ongoing climate crisis whose necessary responses are being pushed aside by rearmament and higher interest costs – the near-term focus among investors will be on whether there will be a soft landing or not, and on how central banks will orchestrate it. Perhaps the effects of interest rate hikes will arrive after a substantial time lag. In that case, there is a risk that economic deceleration will be stronger than predicted and corporate earnings weaker than anticipated. If this should happen, forecasts of future credit events and defaults will also be exceeded. Meanwhile if the decline in inflation is sluggish, there is a risk that central banks will keep the brakes on for too long. Given strained government balance sheets, the fiscal stimulus weapon will not be available.

Our analysis indicates that there is a greater likelihood of disappointments about a soft landing than of our forecast being exceeded. But at the same time, a soft landing remains our main forecast in an uncertain world. In terms of geopolitical risk, an escalation and expansion of the conflict in the Middle East – with Iran stepping in under its own flag – might result in major negative effects.

The balance between an easing of Fed pressure and a slowing economy supports our neutral risk exposure

During 2023, we did not apply recession portfolios but maintained broad risk diversification with a neutral allocation between asset classes. This means that we have been helped by large US growth companies and the strong dollar, as well as the positive momentum prevailing in Sweden among companies with lower-than-average valuations. We have gradually reduced this factor exposure, but we still have a slight overweight in portfolios that are not pure value portfolios. In our fixed income portfolios, we have extended our average maturity after previously maintaining a very short maturity. Our proportion of corporate bonds is slightly higher than in the index. We are overweight in fixed income investments at the expense of alternative investments and hedge funds in mandates that include the latter asset class. Illiquid investments come in many guises, and by definition they have a longer investment horizon – making them excellent complements to a traditional portfolio.

Returns have fluctuated back and forth during the year, but overall, the absolute return in our composite portfolio has surprised on the upside, considering that it includes a period of major geopolitical challenges, central banks slamming on the brakes and global corporate earnings that have been stagnant. During 2024 the situation should gradually improve, but first we must weather a slowdown and patiently await the upcoming interest rate cuts by central banks. Investors are sensing opportunities ahead of the "double turnaround", but there will be pitfalls. For the time being, we are thus content with a normal risk exposure.

Global equities

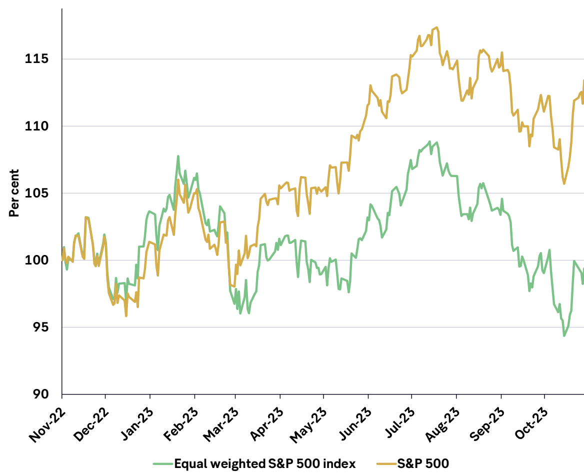
Many are called, few are chosen in this year's market rally

Since the last *Investment Outlook* in September, the world's stock markets have had a tough autumn including broad downturns. The driving force has been rising US bond yields, with continued strong American economic growth and hawkish comments by the Federal Reserve pushing 10-year Treasury yields up to around 5 per cent, their highest level since before the 2008 global financial crisis. The market downturn should also be viewed in light of the rally earlier this year. But in recent weeks, stock markets have recovered some lost ground following more dovish comments by the Fed, among other factors. This was triggered by a tightening of "financial conditions" (loan costs, changes in asset values, the USD trend etc.), which have the same cooling effect as an interest rate hike. Recent statistics generally indicate a bigger downturn in various inflation measures than expected – boosting investor hopes that interest rate cuts will come sooner and leading to a significant positive stock market reaction.

To sum up the year so far, most stock markets show clear upturns. The gloomy macroeconomic climate – with weak growth and high inflation – is not favourable for equities, but the broad equity indices have nonetheless shown a positive performance, which is unusual. Leading this trend is America's growth-heavy Nasdaq Composite, along with the Japanese stock market, where local-currency valuations have been pumped up due to the weak yen.

Meanwhile the Stockholm stock market and small caps, both globally but especially in Sweden, are among the losers. Most equities have nevertheless had a very tough period, but a small number of giant growth companies have pulled the broad indices higher. If we exclude them, performance is more in line with what we would describe as normal, which can be illustrated by a comparison between the US S&P 500 market cap weighted and equal weighted indices.

Narrowly based US stock market upturn this year

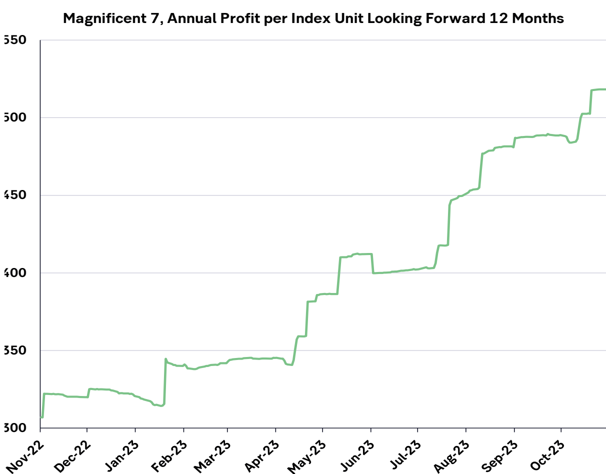


Source: Bloomberg

The chart shows the performance of the market cap weighted S&P 500 and its corresponding equal weighted index. The image of the past 12 months as a good stock market year is undermined if all 500 companies in the index are given equal weight, in which case the average return is actually zero.

The upturn in the growth segment is explained largely by the "Magnificent Seven" – the mega-cap stocks Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. Together they account for most of the upturn on US stock exchanges this year. In the Nasdaq index they have a combined weight of 45 per cent, and in the S&P 500 they represent nearly 30 per cent. It is also noteworthy that they constitute nearly 18 per cent of the benchmark MSCI global index, about as much as all of Europe! These seven companies share such features as market dominance, strong balance sheets, strong cash flow and, in most cases, rapid growth.

Steady upward revisions for the biggest tech companies

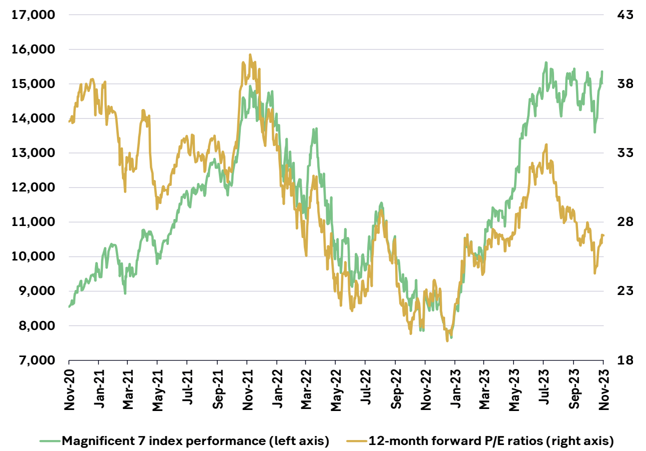


Source: Bloomberg

The Magnificent Seven show impressive earnings growth. Of these companies, Nvidia boasts by far the highest earnings growth rate while Apple has the slowest growth.

Although the Magnificent Seven have much higher valuations than the rest of the stock market, they have managed to cope with interest rate hikes, which is partly explained by the fact that investors are searching for artificial intelligence (AI) related exposure. This in itself is surprising since it is still unclear whether and, if so how much, AI can contribute to their bottom lines.

Magnificent Seven steaming ahead – valuations are relatively high, but are they justified?



Source: Bloomberg

Magnificent Seven shares (in an equally weighted index consisting of Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla) have risen 80 per cent over the past three years and have served as an engine for the broader indices. Valuations are certainly high, but not alarmingly so.

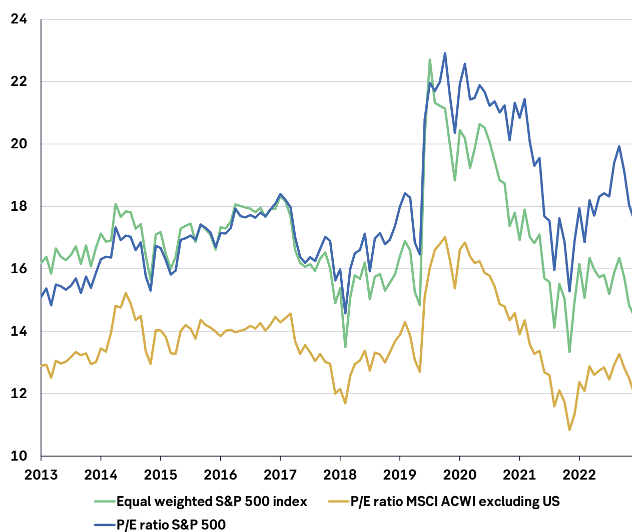
However, there is one clear AI related winner, Nvidia – the least known of the seven companies but also the one that has attracted the most attention this year. Among the products designed by Nvidia are the sought-after graphics processing units (GPUs) needed for the many repeated calculations required to train machine learning models. Nvidia was also an early supporter of OpenAI and built a special calculation module based on its processors to speed up the training of language models being developed by that company. In late May, when Nvidia revised its second quarter sales forecast upward by 50 per cent, the effect was explosive. Its share price, which had already risen 100 per cent, climbed a further 27 per cent on the day the announcement was made. It was then clear that the AI race was in full swing. However, expectations are high – after-tax earnings this year are expected to be more than USD 6 bn and then grow to USD 26 bn in 2024 and USD 42 bn in 2025, according to analyst consensus forecasts.

Nvidia started in 1993 as a semiconductor company that designed GPUs and quickly became a major supplier to the gaming industry, which was experiencing rapid growth. Somewhat unexpectedly, the cryptocurrency mining industry also became a big market for the company, with its graphics cards consequently in short supply for a number of years. Through both luck and skill, Nvidia has emerged as the top player in one of the fastest-growing niche markets. AI is expected to have a revolutionary impact on many sectors, and enormous sums are being invested in this field. Advances are occurring at a dizzying pace, and Nvidia is the stand-out winner – thus its earnings explosion and skyrocketing share price.

Third quarter earnings reports were better than feared – especially in Sweden and largely in the US – while they were weaker elsewhere in Europe. Companies have generally handled slow growth and rising interest rates well, with price discipline and cost control compensating for falling volumes. However, order books and organic growth are on the decline, as the report period clearly showed. This will be a challenge going forward. The aggregate consensus forecast, a 10 per cent rise in global earnings, looks overly optimistic. Periods of downward-revised forecasts often sour the market mood even though they are expected.

With earnings trending flat and share prices higher year-on-year, share valuations have risen during 2023. However, this is entirely due to a few index heavyweights such as Apple, whose multiples have expanded.

If we ignore the biggest US growth companies, valuations are lower today than 10 years ago

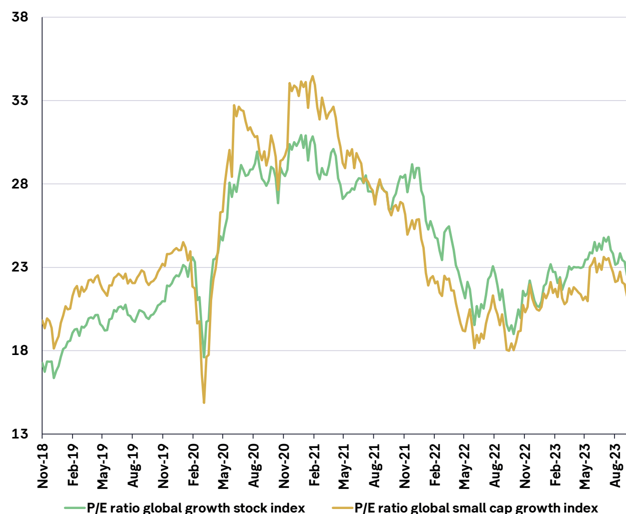


Source: Bloomberg

The chart shows 12-month forward price-earnings ratios for three indices over the past 10 years. The S&P 500 has been pulled up by growth companies, with their heavy index weight, whereas the equal weighted S&P 500 index and the benchmark MSCI All Country global index excluding the US have fallen to historical lows.

In contrast, some market segments have seen valuations fall, which may lead to investment opportunities. One such segment is small cap growth companies. As a rule, the share price trend for companies with high valuations whose revenue streams lie far in the future is worse than for companies with low valuations when interest rates rise, due to higher discount factors. This has been the case for global stock markets this year, except for big US tech companies that have ridden the AI wave. However, valuations for smaller growth companies have fallen significantly. As a rule, smaller companies have higher earnings growth than bigger companies, which is rewarded in a positive market climate. However, these companies have less diversified operations and weaker balance sheets, which has been a disadvantage in the inflationary environment of the past couple of years. Investors have also been relatively risk-averse, which puts small companies at a disadvantage. Nevertheless, inflation has turned downward and bond yields have started to fall in recent weeks, a trend we believe will continue. That paves the wave for multiples expansion and earnings growth for smaller growth companies.

Valuations have fallen greatly for small growth companies, compared to big ones



Source: Bloomberg

The chart shows valuations measured by P/E ratios over the past five years for small and large growth companies. There has been a significant revaluation for smaller growth companies in recent years, especially compared to large ones, which as a rule have stronger balance sheets and greater diversification of revenue streams. Should interest rates fall, and if the economy stabilises – which we believe will be the case – there is considerable valuation upside for smaller companies, which as a rule have higher earnings growth.

After a lengthy period during which professional investors indicated in surveys that they were cautious about equities and portfolios – with an underweight as well as defensive portfolios in their equity exposure – we have now approached a more normal situation in a historical perspective. This is rooted in the belief that there will be a soft economic landing and lower interest rates going forward, which is also our forecast. As long as there are risks here, we will continue to take a slightly cautious approach to equities and other risk assets, with normal weights and good risk diversification as our guiding principles. But because of flows, sentiment and herd behaviour, some stock market segments have been punished too severely. We note that small growth companies now have attractive valuations, which will limit their downside and allow for more positive performance when sentiment strengthens. They should also outperform the market if our macro scenario proves correct.

Nordic equities

Challenges remain

Rapidly rising interest rates and bond yields have been the biggest cause for concern in the stock market over the past two years. Yields have probably peaked. Inflation has fallen dramatically from its 2022 high, and forward prices indicate that central banks, led by the US Federal Reserve, will cut their key interest rates in 2024. The European economy is weak, but leading indicators have probably bottomed out. Normally, this combination would point to a stock market surge in the year ahead, but we see two important reasons for taking a more cautious approach. With real interest rates high, relative stock market valuations are not particularly attractive. It also remains unclear how much earnings will be hurt by this autumn's upturn in market yields. One area being hit very hard by this upturn is the green transition. Small companies have also been squeezed much more than large ones, so there are now probably bargains to be had for individual equities even though valuations are not attractive at the index level.

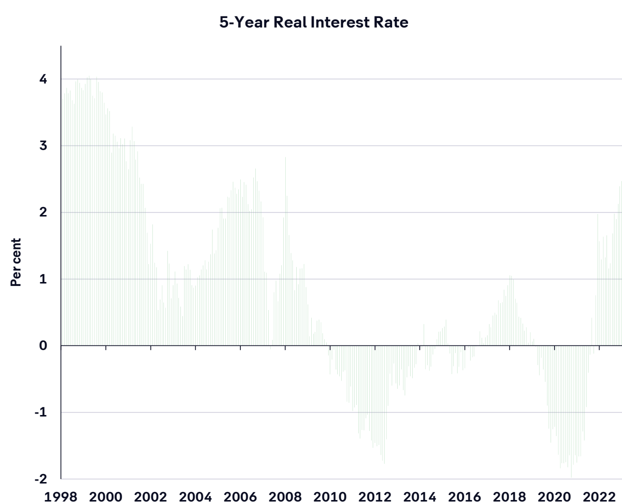
Rates have probably peaked, but high real rates a concern

US market yields fell sharply in early November following signals from the Fed, which the market interpreted to mean that the central bank is now finished with its key rate hikes in this cycle. The fixed income market has currently factored in a nearly 1 percentage point cut in the Fed's key rate in 2024, though probably not until the second half. US monetary policy and the American fixed income market have a large impact on the world, especially Europe, and long-term yields have fallen relatively far from their October peaks.

We have probably seen the worst regarding interest rates and yields, and some relief is expected in 2024. This is very favourable for the stock market and explains November's strong start. The rate/yield upturn in 2022-23 has been a major impediment for the stock market during that period. It is thus tempting to conclude that, with yields having peaked, stock market lows should also be behind us, but we fear that may be a hasty conclusion. The latest downturn in yields was preceded by a very sharp upturn in the late summer and autumn. The upturn in real interest rates was especially noteworthy.

Real interest rates are still very high in a short-term historical perspective, and since there is a significant time lag before their impact on listed company earnings is apparent, we fear the stock market will remain unstable for the rest of this year and in early 2024. Of course, the stock market and the economy managed to deal with even higher real interest rates than today's in the late 1990s, but some caution is needed in making such a comparison since – due to decades of monetary stimulus and negative interest rates – some segments of society are far more indebted than historically. This is also true of the business world, and some economic sectors have built access to cheap credit into their business models.

Historically high real interest rates represent an enormous adjustment – it is hard to determine the cost



Source: Bloomberg

The chart shows yields on five-year US inflation-indexed bonds. This is an enormous adjustment after 15 years of ultra-low yields. Real interest rates were even higher 23 years ago, but since then the debt situation in large parts of society has changed dramatically. Today the fixed income market is a tough competitor to the stock market in attracting investor funds. Meanwhile, real-term investments are being held back, which should further subdue demand going forward.

Leading indicators have probably bottomed out, but not earnings

This year, purchasing manager indices (PMIs) and other important leading indicators were at historical lows before turning somewhat higher. For some of the most influential indicators, such as Germany's Ifo business climate index and America's ISM manufacturing PMI, last summer's troughs were the lowest in 20 years apart from the 2008 financial crisis and right after the outbreak of COVID-19 in the spring of 2020. Although another decline in leading indicators cannot be ruled out and the economic recovery has not yet shown much strength – in clear contrast to the recoveries in 2009 and 2020 – it is likely that we are already over the worst.

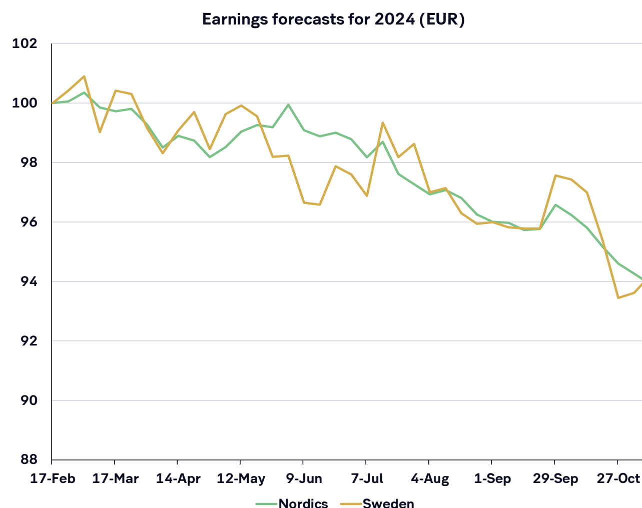
The current slump is unlike any of the others over many decades – in that weak economic activity, especially in Europe, is combined with the highest key interest rates in about 20 years. When the COVID pandemic broke out, during the euro crisis and during the 2008 global financial crisis, central banks tried to stimulate weak economies with enormous quantities of cheap funding.

The situation is now the reverse. Although monetary policy will probably be somewhat less restrictive during 2024, we are still in an environment where central banks have done their best to further constrain economic activity. Nonetheless, consensus expectations are that we will have a "soft" economic landing, but it remains to be seen exactly what impact this will have on corporate earnings. The analysts behind these consensus earnings forecasts have no previous experience with a macroeconomic climate like this one – nor do corporate executives. That should mean more uncertainty and a greater risk of revisions than normally.

SEB lowered its earnings forecasts for 2024 slightly after the third quarter corporate report season, but we still expect earnings growth of close to 8 per cent for Swedish companies in 2024 and 11 per cent in the Nordic region. The consensus also anticipates similar earnings growth in 2024, but earnings forecasts have been steadily adjusted downward this year. The downward revision trend in Sweden is especially clear if we disregard the effect of the weak Swedish krona by looking instead at earnings in euro terms.

Consensus forecasts are the most reliable indicator of earnings growth in the near term, but we believe that there is unusually great uncertainty at present. The pattern over the next few quarters may be significantly different compared to the cyclical turning points over the previous 20 years. There is thus an unusually high risk of further downward revisions over the next few quarters, which may well dampen stock market sentiment.

The earnings outlook has gradually deteriorated this year



Source: Bloomberg, SEB

The chart shows aggregate 2024 earnings forecasts for the OMXS30 and VINX 30 in euros, indexed. Forecasts have gradually been revised downward during the year. To avoid being misled by the effects of the falling Swedish krona, earnings have been calculated in euros, both for the Nordic countries as a whole and for Sweden in particular.

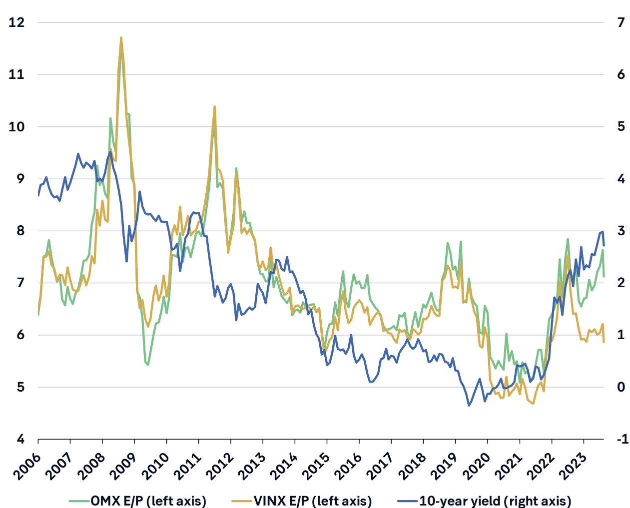
Relative valuations are unattractive

Despite the biggest upturn in real interest rates in modern times and downward-revised earnings forecasts (in Sweden and the Nordics as a whole), the stock market has climbed this year. As a result, equity valuations are less attractive, especially compared to fixed income investments. For the Stockholm stock market, the risk premium on equities compared to government bonds is near its lowest level in 10 years. The Nordic market as a whole looks even more expensive but is strongly affected by the Danish pharmaceutical giant Novo Nordisk, which alone accounts for over 22 per cent of the Nordic index and is undeniably in a unique situation, with exceptionally strong growth in demand for the company's GLP-1 medications.

In the US, the risk premium for the S&P 500 is the lowest in more than 20 years. Not since the final phase of the dot-com crash around the turn of the millennium have share valuations been as high as today compared to fixed income investments. However, the risk premium for corporate bonds is more normal, which has led to a unique situation where yields on BBB-rated bonds – which are of fairly good quality and have been issued by such well-known corporations as AT&T, GE and GM Financial – are higher than the forecast earnings yield (E/P ratio, or earnings divided by the market share price) for the S&P 500 index.

High valuations need not be a problem for the stock market, but they result in demands for rapid earnings growth and make the market sensitive to potential setbacks. The margin of safety for downside surprises is now minimal, and any setbacks in the US will also have a significant impact on the Nordic stock market.

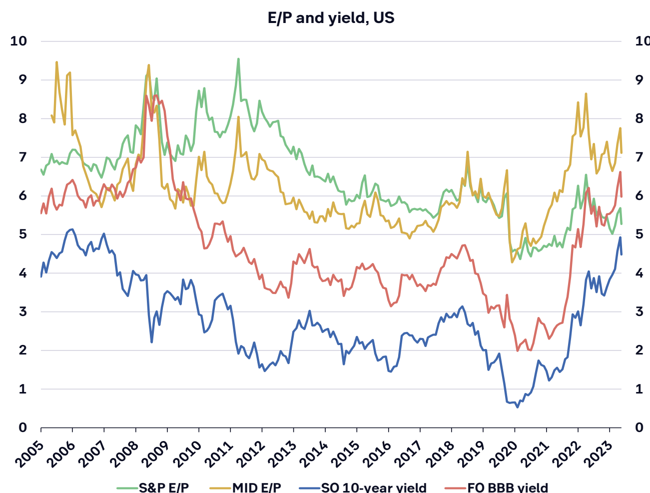
Given the upturn in yields, bonds offer tough competition for capital



Source: Bloomberg, SEB

The chart shows the E/P ratio (inverted P/E ratio or earnings expressed as a return to shareholders) for Swedish and Nordic large caps compared to the yield on 10-year Swedish government bonds on two different scales. The difference in the scale, 5 percentage points, is somewhat less than the average historical risk premium for Swedish equities over the past 15 years. Historically, investors have normally required greater compensation for the higher risk of investing in equities compared to government bonds than is the case today.

In the US, the risk premium on large cap stocks is historically small



Source: Bloomberg, SEB

The chart shows the E/P ratio (inverted P/E ratio or earnings expressed as a return to shareholders) for US large caps (S&P 500 LargeCap index) and US mid caps (S&P 400 MidCap index) as well as yields on 10-year US government bonds and 10-year US corporate bonds with a BBB rating (a relatively good rating – for example, AT&T, GE and GM Financial have this rating today). Higher risk-free yields have pushed up return requirements on corporate bonds and mid cap equities (S&P 400 MidCap index), but average valuations for the biggest companies remain high, which means a very low average risk premium for S&P 500 companies.

Interest rate upturn is slowing green transition

Since the impact of higher interest rates is first seen after a time lag, we should be prepared – within the next six months or so – for this year's big interest rate upturn to become more visible, perhaps in fourth quarter 2023 earnings reports and even more so in earnings reports for the first two quarters of 2024 than it has been so far. However, in some economic sectors, this trend has already been devastating – for example, residential construction and portions of the real estate sector as well as consumer durables – but the green transition and especially the transition to clean energy have now also slowed dramatically.

The sharp decline in the share prices of green or environmental tech companies is partly a function of higher return requirements, which have led to lower valuation multiples, but this collapse has largely been caused by a sharp deterioration in market conditions. The most dramatic example in the Nordic countries is the Danish renewable energy company Ørsted, whose share price fell nearly 80 per cent from its peak, wiping out nearly DKK 450 billion of its market value. In comparison, the largest Swedish company on the Stockholm exchange, Atlas Copco, today has a market value equivalent to DKK 485 billion, and the second largest, Investor, is worth DKK 420 billion.

Ørsted was a pioneer in building offshore wind farms and continues to be a leading player in their design, but it also invests in onshore wind power and solar farms. Offshore projects in particular are large and complex and take a long time to build. Like virtually every other industrial firm, Ørsted has been affected by cost increases in recent years as well as company-specific problems.

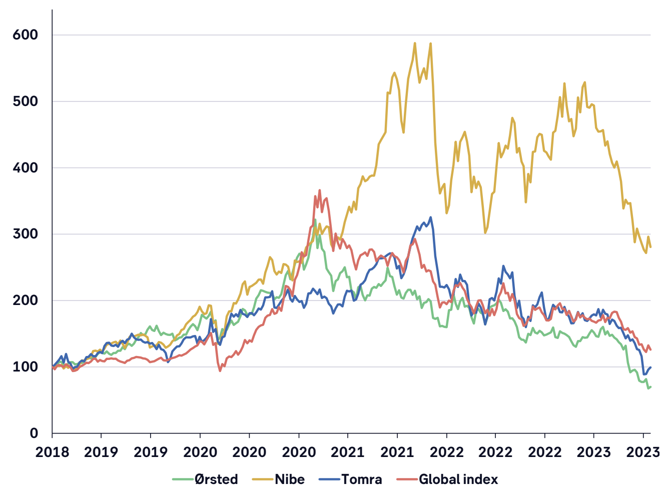
Most importantly, Ørsted is caught in a bind when capital costs increase dramatically because of higher interest rates and bond yields. Revenue is based on long-term fixed rate contracts for the electricity that will be generated. Consequently, several large projects that have already been launched are no longer economically viable. Like many of its competitors, the company has been unable to renegotiate its electricity rate contracts and has instead chosen to abandon projects, leading to billions of DKK in losses. The steep fall in Ørsted's share price is not just because of the losses already reported, but also a deterioration in its potential to build new projects that will generate profits as well as lower profitability in existing projects.

Ørsted is far from alone in having these problems. Several competitors have been hit by the same problems, but few have had such aggressive growth investment plans. There have also been numerous profit warnings from companies throughout the solar energy sector value chain. Everything from green hydrogen to green steel will also depend on a major expansion in renewable energy production, which means these kinds of projects will also be subject to greater scrutiny. There is still rapid growth in electrification and expansion of the power transmission grid. Only the parts that are specifically related to electricity transmission from offshore wind farm projects have been halted so far, but in the long term these projects are of course also related to the continued expansion of renewable energy production. Calculations for energy efficiency solutions such as heat pumps must also factor in electricity and interest costs compared to fuel oil or natural gas, a comparison that has deteriorated significantly in Europe over the past year as interest rates and yields have skyrocketed and gas prices have fallen.

Submarkets such as roof-mounted solar panels and heat pumps for homes are characterised by short lead-times. Both segments will probably soon see the full impact of the interest rate upturn, but the larger the project the longer the lead-time. This means that a lot of construction activity in offshore wind power, for example, that began one year ago or earlier and was in the planning phase more than 10 years ago will continue until completed.

The impact of what is happening today will only be reflected in statistics a few years from now. It remains to be seen whether there will be a political response to the problem and if so what. It has not helped share prices in this sector that we have recently seen a major shift in political priorities. For example, countries such as the United Kingdom and Germany have lowered their ambitions for the transition to more energy-efficient space heating sources, since it is considered too costly for household finances in a situation of high interest rates and food prices.

Sharp decline in green share prices due to higher interest rates



Source: Bloomberg

The chart shows the indexed share price trend for three large Nordic companies with solutions for a more sustainable society: Ørsted (renewable energy), Nibe (heat pumps) and Tomra (recycling). It also shows a broad global index of companies that provide solutions for the green transition, which has fallen by more than half in two years. The transition to a more sustainable economic model – especially the transition to cleaner energy – is interest rate-sensitive, and the upturn in rates and yields over the past year is now slowing investments by many companies and households in this field.

Selective bargains among squeezed small caps

The combination of high interest rates and yields, which have probably peaked, and leading economic indicators – which have probably just come out of their third-deepest trough in more than 20 years – makes it very tempting to adopt an outright bullish outlook on the stock market. Going forward, two of the very most important factors for the stock market will be better than they are today. Unusually high uncertainty about the earnings outlook, and thus the risk of revised forecasts, are not at all unusual in this kind of situation, but that is often offset by really low valuations. Today's valuations are not particularly low, which does not leave much room for disappointments, making this the biggest challenge to adopting a more positive outlook on equities right now.

Yet there are big differences between various market segments. Small cap shares have performed much worse than large cap shares, not just in the Nordic region and Sweden specifically but also in the US. The spread in valuations between different groups of US companies is illustrated in the chart, which shows the valuations of US mid caps (S&P 400 MidCap) compared to S&P 500 companies, among others. The big spread between these groups, in turn, is explained virtually in its entirety by seven of the largest companies in the index and not by the other 493.

In Sweden, valuations for small caps are still higher than for companies in the OMXS30 index of most actively traded equities, making it hard to argue that they are especially undervalued as a group, although the small cap index has fallen 30 per cent since January 2022 and the OMXS30 has slumped only 10 per cent.

This is partly explained by the greater negative impact of the economic slump and interest rate increase on small companies, which have had slower earnings growth, especially during the past 16 months. The other explanation is that a number of the larger companies in the small cap index, whose shares are often especially popular with small cap funds, still have valuations at very high multiples.

Some of the more expensive equities are valued at higher P/E ratios, based on forecast record earnings, than such US growth standouts as Nvidia and Tesla. This has pulled up the overall P/E ratio for the index. Below the surface, however, a lot of small cap equities have become really cheap. On the Stockholm exchange, 133 small caps today are valued at a discount to their book equity value – more than one in three companies, excluding the 30 largest. Of course, many of these are loss-generating companies or real estate firms whose equity capital calculations are not trusted by investors, and some are investment companies for which a certain discount is totally normal. It also means that market expectations are low today for many smaller companies.

One sector that we think is especially attractive today, and where many shares are valued well below a reasonable long-term level, is real estate. Over time, real estate companies should have valuations relatively close to net asset value. If they are significantly cheaper, they will be bought up by someone who wants to own the underlying assets and can get them at a discount. If listed real estate shares are generally valued far above the market value of their assets, this will instead attract new companies and funds to the stock market until the supply of real estate shares corresponds to investor demand and a more balanced valuation is reached again. Right now, the 25 real estate companies that SEB follows have an average discount to net asset value of 41 per cent, which is equivalent to an implicit expectation of an 18 per cent decline in the value of their properties, or that their balance sheets have to be refinanced in a way that dilutes the value for existing shareholders.

So far, the average company has written down the value of its properties by 6 per cent, and we believe a further 9 per cent write-down will be needed. The average share price has thus factored in twice as big an impairment loss. In some cases, this discount reflects great concerns about an imminent need for refinancing, but that is not an adequate explanation for most others. Real estate companies stand out because they are highly sensitive to interest rates and bond yields, and the problems already created by the interest rate upturn are clearly reflected in these valuations. Some segments are also scarcely cyclical – this is especially true of residential properties, but also premises for public sector tenants. So far in this business cycle, offices with good locations and warehouses/manufacturing premises have been surprisingly stable. The combination of low valuations, interest rates that have peaked, and in many cases somewhat limited sensitivity to the business cycle is clearly appealing in the current macro environment.

The smallest companies have fallen sharply

If small companies on the Stockholm stock exchange have seen a big market downturn in recent years, the smallest companies – which are often listed in other marketplaces – have had a brutal downturn. The First North exchange index is down 10 per cent over five years and 63 per cent from its peak in early 2021. A search on Bloomberg indicates that 48 Nordic companies with net holdings of cash equivalents are currently valued at less than these net holdings. However, in almost every case they are loss-generating companies with a market value of less than one billion Swedish kronor. This group includes a number of stocks that were red-hot during the pandemic.

We do not advocate a strategy based on buying small companies valued at less than their equity or micro companies valued at less than their net cash equivalents. If investors are not selective, this is a very risky strategy that will probably add many bankruptcy candidates and problem-plagued companies to their holdings. The point of the above figures is that they illustrate how divided the market has become and that after the sharp fall in small cap share prices in the past few years, there are now many small companies with really low valuations.

Some stock market segments are so cheap that there should be good investment opportunities for long-term and risk-tolerant investors, although the stock market as a whole does not look cheap – not even small companies as a group do. But even now, there should be good potential for selective investments in small cap equities.

As in the US, share prices of small Swedish listed companies have fallen much more

Source: Bloomberg

The chart shows the performance over the past five years of the OMXS30 index of the 30 most actively traded shares on the Stockholm stock exchange, the OMX Small Cap index and the index for companies on First North (very small listed companies). Over the past five years, the small cap and large cap indices delivered similar performance, whereas the First North index performed far worse: down 10 per cent in five years and 63 per cent from its February 2021 peak. Bubble valuations for small and micro companies were more extreme than for large caps in 2021, but after the recent sharp downturn there should now be good opportunities for selective bargain purchases.

Fixed income investments

A lengthy rate hiking journey has reached its end

After hiking their key interest rates at every possible opportunity since the first half of 2022, both the US Federal Reserve (Fed) and the European Central Bank (ECB) have refrained from raising rates at their most recent policy meetings. There is no doubt that their hikes have had an impact. Inflation has fallen sharply, while economic activity has slowed. The two central banks have also been helped in their work by higher long-term yields and tighter financial conditions, which have further cooled the economy. As a result, in our view central banks such as the Fed, the ECB and Sweden's Riksbank have now implemented their final rate hikes. The focus has now shifted instead to the timing of their first rate cuts, which are expected to occur next year. We believe that the Fed and the ECB will be the first to cut their rates in mid-2024, while the Riksbank will wait until September.

Government bonds (excluding emerging markets)

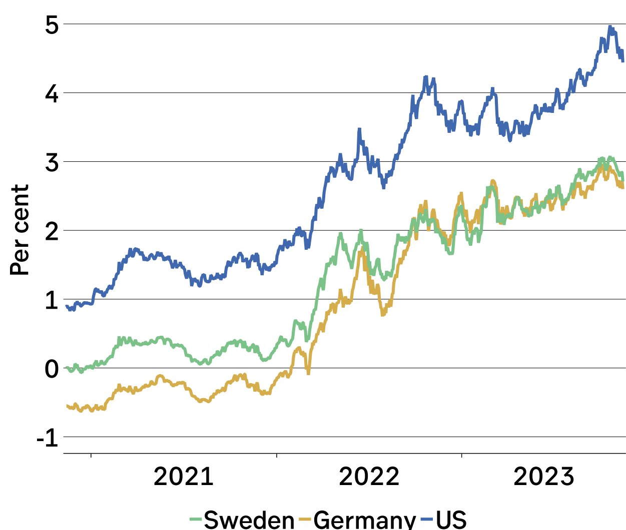
The focus of market attention over the past few quarters has been on the performance of long-term government bonds – first when yields climbed in the early autumn and then when they fell in November. At that time, interest rate decisions by the Fed and the ECB were interpreted as indicating that key interest rates had peaked. But other driving forces are also in motion. One is expectations about monetary policy and key rates, with the market giving more credence during the autumn to the central bank mantra "higher for longer", but still expecting short-term interest rates not to rise, thus triggering a downward correction. This argument is also based on cyclical factors – in our view, central banks now believe that they have administered a sufficient dose of monetary tightening to bring about the economic slowdown needed to reach their inflation targets.

In the US, different driving forces are acting in different directions, but we believe that key interest rate cuts will be the main driver for lower US bond yields in 2024 and 2025. However, weak public finances, continued large deficits and high borrowing requirements will work in the opposite direction, causing investors to demand a higher maturity premium. Overall, our view is that impending rate cuts will cause US 10-year Treasury yields to fall to 4.30 per cent by the end of 2024 and then continue down to 4.00 per cent by the end of 2025.

In the euro area, the potential for lower yields is more limited. One result of the ECB's earlier bond purchases is that yields on government borrowings by the major countries in the region are significantly depressed compared to the central bank's key interest rate. The effects of a lower key interest rate in the second half of 2024 and of continued ECB bond sales will basically cancel each other out, with limited downward potential, especially for Germany. Our forecast is that German 10-year government bond yields will trend flat and trade at around 2.50 per cent by the end of 2025.

As for Sweden, our forecast is that the Riksbank will not raise its key interest rate any further, leaving it at 4.00 per cent until autumn 2024, when the central bank will carry out its first 0.25 per cent rate cut. The National Debt Office will most likely increase bond issuance volumes next year, since weaker Swedish government finances and the Riksbank's recapitalisation suggest that more bonds will be needed. We also expect the Riksbank to expand its bond divestments and thus indirectly increase quantitative tightening. The yield spread between Swedish and German 10-year government bonds has widened, and this trend is expected to continue. All in all, these factors suggest that Swedish 10-year bond yields will remain largely at their current level at the end of 2025.

Expectations that the rate hiking cycle is over have brought long yields down



Source: Macrobond

Economic data, which show with increasing clarity that interest rate hikes have had an impact and that central banks are finished with their rate hikes, have caused long-term bond yields to fall. The focus of market attention has now shifted to impending interest rate cuts.

Government bond forecast

10-year government bond yields	Nov 9	Dec 2023	Dec 2024	Dec 2025
United States	4.61	4.80	4.30	4.00
Germany	2.70	2.75	2.60	2.50
Sweden	2.85	2.90	2.90	2.80

Source: SEB, forecasts November 2023

Ten-year government bonds are expected to peak around the end of 2023. However, performance will then vary, with US long-term yields falling while Swedish and German long-term yields trend flat.

Corporate bonds – Investment grade (IG) and high yield (HY)

Corporate bonds with high creditworthiness (investment grade) have seen the last of a volatile price period, since the trend for this kind of bonds depends more on movements in underlying government bond yields (interest rate risk) than on market movements that affect fundamental company-related factors (credit risk). Meanwhile, because of the sharp upturn in government bond yields, which has had an adverse effect on corporate bond prices, current IG bond yields are historically high. Credit risk measured as the credit spread – the difference between yields on corporate and government bonds with the same maturity and in the same currency – has also fallen over the past two years, with corporate bonds currently trading at their historical average.

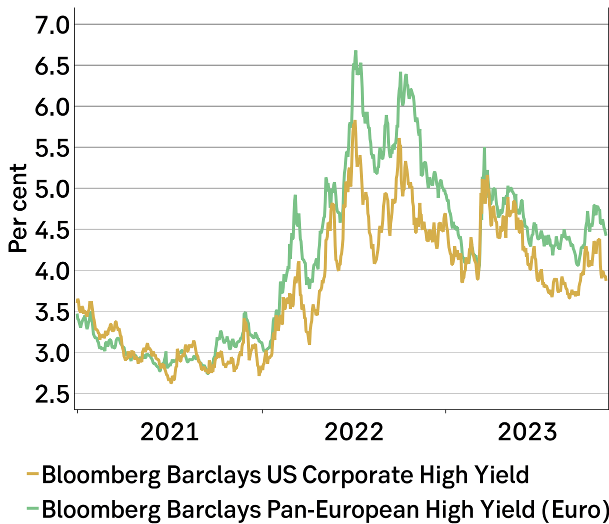
It has been a different picture for corporate bonds in the high yield segment. HY bonds are affected more by conditions affecting the credit quality of the individual company – its ability to service its debts and thus avoid payment default or bankruptcy. Since bottoming out in early 2022, the default rate in the HY segment has risen from around 2 per cent to about 4.5 per cent today. In itself, this is not a cause for concern given that the historical average is around 4 per cent; meanwhile, the credit rating agency Moody's anticipates that the rate will fall somewhat over the next 12 months.

However, one factor that may challenge the HY segment is the large proportion of bonds maturing over the next few years. This means that companies will need to refinance their operations by issuing new bonds or borrowing from banks. Whichever option they choose, this will need to be done at much higher interest rates than those set for maturing bonds. The fact is that many companies took the opportunity to refinance in 2020-22, when interest rates were record-low. This will increase financing costs and indirectly contribute to lower earnings, which in itself increases debt as a percentage of sales. The interest coverage ratio, which measures the earnings divided by interest payments, is also expected to fall when financing costs rise.

In our view, we have reached the end of the road for central bank key interest rate hikes, which will also lead to lower bond yields in the long term. That represents a positive force for corporate bond performance, with IG bonds that are more sensitive to interest rate changes having an advantage.

If the slowdown in global economic growth is sharper than expected and leads to a hard landing rather than a soft one, then credit risk for companies will naturally increase. Meanwhile, however, in such a scenario government bond yields will fall faster, which would partly offset the negative effect of the price of increased credit risk as well as widening credit spreads.

Credit spreads have narrowed as recession fears ease



Source: Macrobond

Credit spreads have narrowed again, this time due to lower inflation and expectations that the rate hiking era is over, which has indirectly lowered the risk of recession. However, debt refinancing over the next few years at higher interest rates may be a problem

Emerging market debt (EMD)

The surprisingly strong resilience of the US economy has indirectly created a problem for most emerging markets. The strength of the American economy over the past six months has caused yields on USD-denominated debt to rise all across the yield curve, as both short-term key interest rates and long-term bond yields moved higher. In co-variation with interest rate movements, the US dollar also appreciated greatly during the same period. Meanwhile, China has struggled with challenges in the form of a real estate sector in crisis, lower domestic demand and a strained geopolitical situation – which has led to downward revisions in economic growth. These factors have led to more difficult conditions for many emerging markets, whose USD-denominated loans have grown in local currency terms and at the same time have become more expensive to service. Slower economic growth in China, in turn, means reduced economic activity for countries that have previously conducted a great deal of business there.

However, there is now reason to foresee a brighter future as inflation continues to fall and central banks around the world end their monetary tightening, instead replacing it with interest rate cuts. This is especially true of most emerging markets, where inflation has fallen steadily for some time and there is plenty of room for rate cuts – which should benefit both the yield trend and economic growth. Given that growth conditions vary between countries and sectors, our recommendation is to be selective and take into consideration the fact that near-term refinancing will be done at much higher interest rates than previously. The Federal Reserve is expected to be among the first – and possibly the quickest – to deliver key rate cuts. This should provide support for lower USD exchange rates and lower interest on USD-denominated debt during 2024.

Two factors that might challenge this somewhat brighter future are a renewed surge in inflation and a further postponement of interest rate cuts. This would exacerbate credit risk factors, given a tougher economic climate. The global geopolitical situation has become increasingly tense over the past two years, and further escalation would have a direct negative impact

Theme: GLP-1 is changing the world

GLP-1 medications such as semaglutide and tirzepatide, used for treating overweight and type 2 diabetes, have recently revolutionised health care. Novo Nordisk and Eli Lilly dominate the market with their successful GLP-1 molecules. These drugs are predicted to not only change treatment of overweight and diabetes but also affect our societies through changes in consumption patterns, and they may have a significant economic impact.

Sales of semaglutide and tirzepatide to treat overweight and type 2 diabetes are growing sharply. Revenue for the most recent quarter at an annualised rate was about USD 6 billion to treat overweight and USD 22 billion to treat type 2 diabetes respectively. Studies indicate that cardiovascular diseases can also be improved with GLP-1 medications. The molecules in these medications imitate the body's own GLP-1 hormone and increase the production of insulin in its cells, inhibit the production of glucagon and increase the feeling of fullness. GLP-1 drugs have potential to change the world in numerous sectors as overweight treatment improves. There are ongoing studies of new medications that stimulate various hormones and may be even more effective in weight reduction, which in turn can reduce the number of severe secondary diseases. These medications are a big step for patients but also a potentially giant leap for mankind. For companies that sell these drugs, the market may grow many times larger, since overweight is more common than normal weight in many countries.

Two companies dominate the market today

While there is an increased number of companies working today with the development and production of GLP-1 medications, two pharmaceutical manufacturers dominate the market for treating type 2 diabetes and obesity: Novo Nordisk and Eli Lilly. Semaglutide from Novo Nordisk has a higher market share than tirzepatide from Eli Lilly. However, Eli Lilly's drug got off to a much stronger start since it was launched during the second quarter of 2022 for type 2 diabetes and soon afterward for weight reduction. The efficacy of semaglutide and tirzepatide has caused a paradigm shift in overweight treatment. Never before have there been weight treatment medications with similar efficacy.

These medications are a big step for patients but also a potentially giant leap for mankind."

According to the World Obesity Atlas, 764 million people globally suffered from obesity in 2020, with a body mass index or BMI above 30 (kg/m^2), which has an adverse impact on their health. AstraZeneca estimates that one billion people live with cardiometabolic diseases such as diabetes, obesity, cardiac problems and stroke. Morbid obesity leads to a high number of mortalities and numerous secondary diseases. It can also be a risk factor for cancer. GLP-1 medications were initially developed to treat type 2 diabetes. Sales in this market are experiencing rapid growth today. However, sales are growing even faster as a treatment for overweight, with many analysts seeing enormous market potential. Even today, some sales of leading type 2 medications such as Ozempic and Mounjaro probably go to patients who want to lose weight and do not have type 2 diabetes, which is the treatment the two products have been approved for.

Overview of current GLP-1 medications

Product Name	Medication	Company	Launch Date	Indication
Byetta	exenatide	AstraZeneca	2005	T2D*
Victoza	liraglutide	Novo Nordisk	2010	T2D*
Bydureon	exenatide	AstraZeneca	2012	T2D*
Tanzeum	albiglutide	GSK	2014	T2D*, removed since 2018
Saxenda	liraglutide	Novo Nordisk	2014	Overweight
Trulicity	dulaglutide	Eli Lilly	2014	T2D*
Adlyxin	lixisenatide	Sanofi	2016	T2D*
Ozempic	semaglutide	Novo Nordisk	2017	T2D*
Rybelsus	semaglutide	Novo Nordisk	2019	T2D*
Wegovy	semaglutide	Novo Nordisk	2021	Overweight
Mounjaro	tirzepatide	Eli Lilly	2022	T2D*

* Type 2 Diabetes

Source: Company websites and Morgan Stanley

The table above gives an overview of GLP-1 medications, brands, companies, commercial launch year and what type of treatment they have been approved for.

Medications with a molecule that imitates the body's GLP-1 hormone have been available in the market since 2005, when the molecule exenatide was developed by Amylin Pharmaceuticals and commercialised by AstraZeneca as a medication for type 2 diabetes. Today the market is dominated by Eli Lilly and Novo Nordisk with the GLP-1 molecules dulaglutide, tirzepatide, liraglutide and semaglutide. GLP-1 medication is an analogue, a molecule that imitates the body's own GLP-1 hormone, which is released from the small intestine after a meal. It increases the production of insulin from the pancreas after eating. It also reduces secretion of the hormone glucagon from the pancreas, which releases sugar from the liver into the bloodstream. Another effect is that it slows the emptying of the stomach, producing a feeling of fullness sooner. The most recent successful molecules also affect the brain's hunger control centre, the hypothalamus. Today the demand for these companies' products exceeds supply, and manufacturers mainly deliver medications to people already in treatment, which has limited the uptake of new patients.

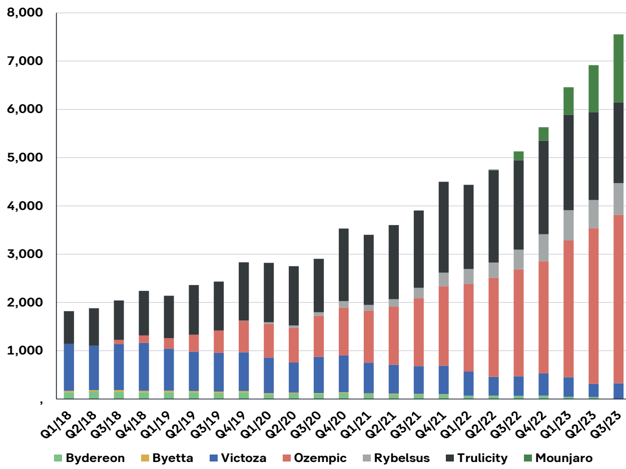
GLP-1 for treatment of type 2 diabetes

GLP-1 medication is not used for patients with type 1 diabetes, since their cells cannot produce insulin. However, people with type 2 diabetes have cells that can produce insulin – though not enough to break down the sugar in their blood. GLP-1 medication can thus replace insulin as long as cells are still capable of producing insulin.

During the first quarter of 2018, Novo Nordisk reported USD 1 billion in revenue from sales of Victoza, its GLP-1 medication for type 2 diabetes, while Eli Lilly posted revenue of USD 700 million from sales of its drug Trulicity. Astra Zeneca reported revenue of USD 170 million dollar from its products Bydureon and Byetta. Last quarter, Novo Nordisk increased revenue from its GLP-1 medications Victoza, Ozempic and Rybelsus for type 2 diabetes to USD 4.5 billion. Eli Lilly reported revenue of USD 3.1 billion from Trulicity and Mounjaro. Sales at Astra decreased.

The investment bank Morgan Stanley recently estimated that in 2023 around 4.4 million patients in the US are using GLP-1 medication for type 2 diabetes, which corresponds to 13 per cent of those suffering from this disease there. A larger percentage of new patients use GLP-1 products than the percentage of all patients, which is driving growth.

Sales of GLP-1 medications to treat type 2 diabetes, USD



Source: Quarterly reports of AstraZeneca, Eli Lilly and Novo Nordisk

The chart shows total quarterly sales for leading GLP-1 medications approved for type 2 diabetes treatment since 2018.

The health care system is increasingly focusing on reducing patient weight, and GLP-1 products have been shown to be efficacious in reducing weight, which also is also boosting their sales growth.

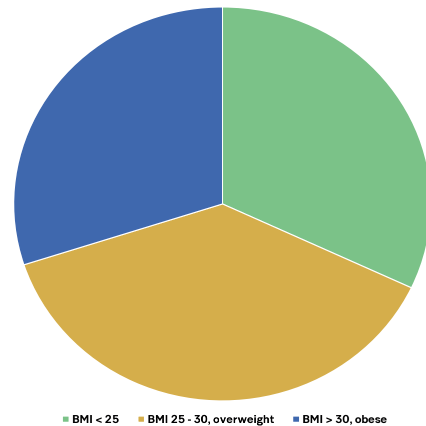
Historically, type 2 diabetes patients who use GLP-1 medication have switched to insulin when the insulin production capacity of their beta cells deteriorates. The greater efficacy of the new GLP-1 medications can delay this effect and thus bolster the long-term market potential for GLP-1 medications as well as reduce the market potential of insulin.

Rapid growth as a weight reduction drug

There has been particular focus in the health care system on excess weight since the COVID-19 pandemic, as there is believed to be a positive correlation between overweight and severe effects from COVID. Today morbid obesity is considered a chronic disease and not – as before – a lifestyle problem. Previously, there were no successful weight reduction drugs. Today, with the new successful GLP-1 medications, doctor prescriptions for new patients are sharply on the rise. Social media have further contributed to the rapid growth in GLP-1 products, with patients sharing their experiences, especially those who have many followers in their networks. The American Diabetes Association has also increased its emphasis on weight reduction for diabetes treatment. GLP-1 sends a signal to a part of the brain to eat less and it slows down digestion, which means the patient feels full sooner.

Studies of Mounjaro have shown that the highest dose of tirzepatide, 15 mg, can reduce body weight by an average of 22 per cent after approximately one year. Wegovy, with a 2mg dose of semaglutide, also reduces body weight by an average of 17 per cent according to one study. Moreover, there are fewer side effects than with previous alternatives. There are huge medical costs associated with morbid obesity. The greatest cost is for people over 60. That is an argument for treating overweight at an early age.

Breakdown of US adults by weight

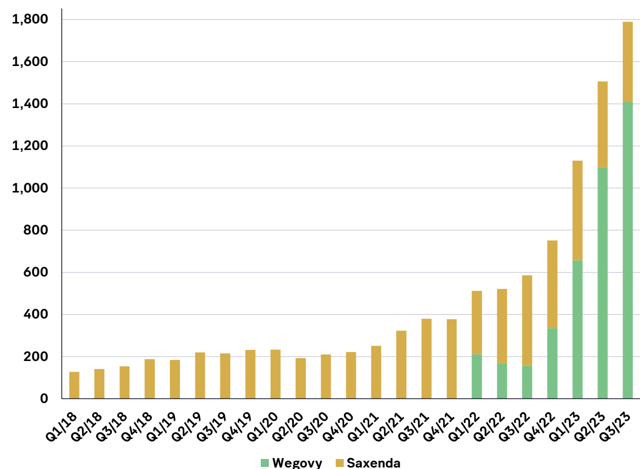


Source: CDC, Goldman Sachs

The chart above shows the body mass index (BMI) of US adults and the percentage who are obese, overweight and with a BMI of less than 25.

Eli Lilly has been granted approval to sell tirzepatide as a weight reduction drug for adults with a BMI over 30, or for those with a BMI over 27 who also have secondary diseases such as high blood pressure. The medication will be sold under the brand name Zepbound. Studies have shown that the drug is more effective, since the molecule also imitates the hormone GIP in addition to GLP-1. Novo Nordisk has two approved drugs and today dominates the overweight treatment market. One of these is Wegovy, which contains the same molecule as Ozempic, semaglutide. It was approved for the US market in July 2021. The company's first product was Saxenda. Total sales of Saxenda and Wegovy were nearly USD 1.8 billion last quarter, an increase of just over 200 per cent compared to the same quarter in 2022.

Sales of GLP-1 medications approved for overweight treatment



Source: Novo Nordisk quarterly reports

The chart shows today's rapid revenue growth for Wegovy, with sales increasing eightfold. Saxenda showed a slight decrease in sales.

According to Goldman Sachs, another investment bank, there are 54 ongoing clinical studies of medications with products similar to GLP-1 for overweight and type 2 diabetes. The bank sees long-term market potential for obesity medications, with USD 100 billion in sales. Today, annualised global sales are about USD 6 billion.

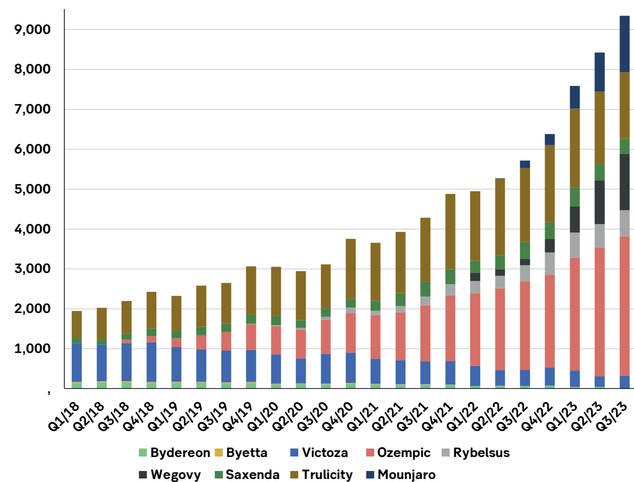
Novo Nordisk and Eli Lilly are developing the next generation of medications, which may be even more efficacious. They are CagriSema (GLP-1 and amylin) from Novo Nordisk and Retatrutide from Eli Lilly, which imitates three different hormones (GLP-1, GIP and glucagon) in combination. Amgen also has two studies on overweight. The company aims to be a leading player in a rapidly growing market, but it will probably take years before it has an approved product on the market.

AstraZeneca has a GLP-1 product in phase one and has also announced that it will buy the global rights for a GLP-1 product from Eccogene. Another big pharma company with studies in this area is Pfizer. In addition, there are other players such as Zealand Pharma, if we focus on slightly smaller companies.

Existing barriers to entry include the long lead-time from initial studies to approved medication. The products being developed must also be at least as good as current products, as well as those being developed by Novo Nordisk and Eli Lilly.

If we combine sales of GLP-1 products for type 2 diabetes and overweight treatment, global sales of GLP-1 medications were about USD 9.3 billion during the third quarter of 2023, equivalent to about USD 37 billion at an annualised rate. Sequential revenue growth was 11 per cent during the third quarter, the same rate as during the second quarter. That is an increase of 425 per cent compared to the first quarter of 2018. Today, the fastest growth in percentage terms is in overweight drugs. In dollar terms, the growth is greatest in type 2 diabetes drugs.

Global sales of GLP-1 medications for type 2 diabetes and overweight



Source: Company quarterly reports

The chart above shows total quarterly sales of GLP-1 medications from AstraZeneca, Novo Nordisk and Eli Lilly.

Selection of clinical study presentations of GLP-1 medications in the near future

Company	Time	Medication	Event
Novo Nordisk	2023	Semaglutide, 2.4mg	Phase 3 data SELECT, heart/vascular, Wegovy
			Phase 3 data, heart failure & overweight, Wegovy
		Amycretin (tablet)	Phase 1 data overweight
	2023/2024	IcoSema (semaglutide & icodec)	Phase 3 data COMBINE 1-3 T2D*
	2024	Semaglutide tablet	Phase 3 overweight 25mg
			Phase 3 overweight heart/vascular T2D*
		Semaglutide	Phase 3 study chronic kidney disease T2D* Ozempic
	2025	CagriSema (semaglutide & cagrilintide)	Phase 3 overweight
		CagriSema / Semaglutide	Phase 3 T2D* & overweight with/without T2D*
Eli Lilly	2023	Tirzepatide	Launch of dieting drug, Mounjaro
	2025	Retatrutide	Phase 2 overweight & chronic kidney disease
		Orforglipron	Phase 3 T2D* adults & poor control of blood sugar regulation
Pfizer	2023	Danuglipron (tablet)	Phase 2 data overweight
Zealand Pharma / Boehringer Ingelheim	2023	Survodutide	Overweight R&D presentation & start of phase 3 study overweight, heart/vascular
Zealand Pharma	2024	Dapiglutide	Phase 2 data overweight
Amgen	2024	AMG 786 (tablet)	Phase 1 data overweight
		AMG 133 maridebart cafraglutide	Phase 2 overweight

*TD2 = Type 2 diabetes
Source: Company websites and Morgan Stanley

The above table above provides an overview of a selection of ongoing studies on current and new GLP-1 medications with an emphasis on overweight, but also other diseases.

Global changes due to GLP-1

In the near term, the focus of market attention is on more details from the SELECT study being carried out by Novo Nordisk. This study may affect the share price of Novo Nordisk but also those of other medical technology and health care companies that provide products and services today to treat diseases that may often be associated with overweight. The study showed that patients taking Wegovy avoid negative cardiovascular events at a greater rate, 20 per cent. Some disease processes can probably be reduced by more than 20 per cent.

Novo Nordisk has also announced that it will end its FLOW study of treatment with semaglutide for patients with chronic kidney disease and type 2 diabetes, following a recommendation from an independent committee monitoring the study since the results met prespecified criteria. The announcement caused shares in Baxter and Fresenius, two companies in the dialysis sector, to fall by 15 and 8 per cent respectively.

The US retail giant Walmart, which also has pharmacy operations, announced during the autumn that its customers being treated with GLP-1 medication have shown major changes in their consumption pattern. Sales of food and beverages have fallen, but this is offset by increased consumption of workout-related products and medicines to reduce the medication's side effects.

Morgan Stanley has conducted studies and interviewed doctors who confirm that the consumption of food and calorie intake decrease sharply since patients are eating less. The decrease is greatest for processed food, soft drinks, alcoholic beverages and sweets. Following Walmart's announcement, shares in major US companies such as Coca Cola and PepsiCo fell 5 per cent.

Better medications for overweight and obesity may have a big positive impact on health care and may affect most companies in the pharmaceutical and health care sector. This may lower the costs of illnesses that may be related to obesity – such as diabetes, gout, arthrosis, liver disease, cardiac problems, stroke, asthma, infertility problems, kidney disease and cancer.

Perhaps we are exaggerating when we say that GLP-1 medications can change the world. But based on current trends, it is clear that they will have a major impact.

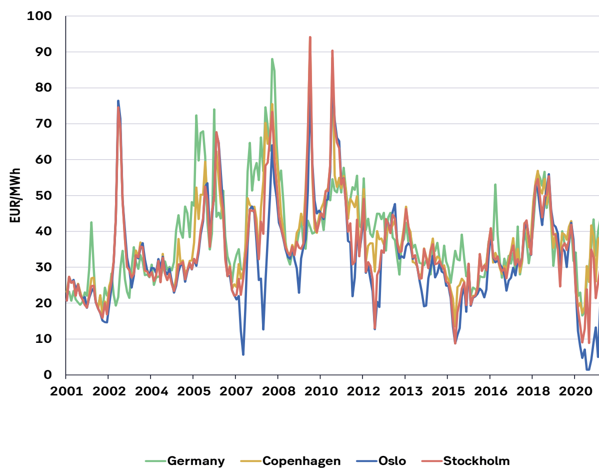
Theme: Electricity markets and their price dynamics

Consumers in Scandinavia tend to believe that electricity prices should be stable, and stable at acceptable levels, since we have a supply dominated by hydroelectric, nuclear and wind power, which all have very low production costs. But pricing electricity as a utility was abandoned in 1990, and since then power markets have turned into traded markets. What does this mean, and what actually determines future developments in electricity markets and our electricity prices?

In some respects, consumers may be right that electricity should have long-term stable prices and be some kind of utility just like water, waste management and roads. These services take a long time to build, require large investments and have long horizons for both operational life and debt servicing. But power priced as a utility was abandoned in 1990. Since then, power in Scandinavia and then gradually elsewhere in Europe was gradually turned into traded markets, with electricity flowing freely across borders according to price signals.

Germany is the heart of the European power market, and what happens there has ripple effects to most power markets in Europe. If we look back at power prices since the start of the year 2000, it is clear that German power prices have generally been setting power prices in Norway, Denmark, Sweden and Finland from year to year.

Monthly power spot prices



Source: Bloomberg

The chart shows monthly spot prices for electricity during a 20-year period (January 2001-December 2020) in Germany, Copenhagen, Oslo and Stockholm.

The trend of electricity prices

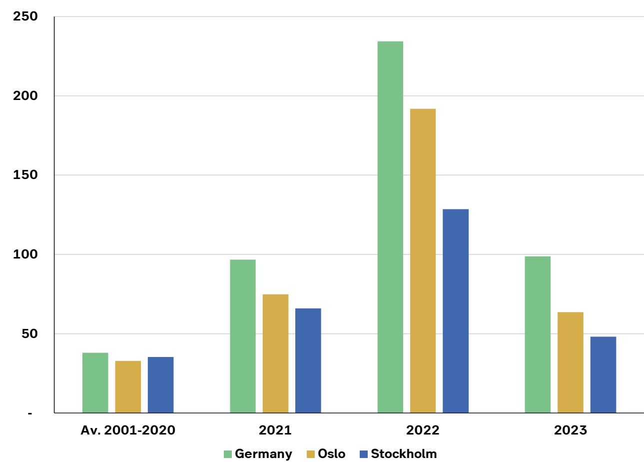
Between 2001 and 2020, the average power price in Germany was EUR 38/MWh. In Oslo (price area NO1) it was EUR 33/MWh and in Stockholm (price area SE3) it was EUR 35/MWh. It is not a coincidence that these averages are so close. The price of natural gas, coal and carbon dioxide (CO_2) was setting the price of power in Germany from year to year. Free flowing electricity across borders then transferred the price in Germany to Scandinavia and elsewhere. Coal, gas, and CO_2 prices were generally quite low during these 20 years, leading Swedish power prices to typically move between EUR 20–60/MWh. These fluctuations in prices weren't noticed too much by private households because they were partially overshadowed by quite high taxes and distribution network costs overall. Fluctuations in hydroelectric power production in Scandinavia from year to year also masked some of the visible relationship between power prices in Germany and Sweden during these years – even more so if you look at monthly and daily data, which can vary much more both locally and across geographies.

The fact remains that power prices in Stockholm as well as Oslo since 2000, and even before that, have broadly been set by the price of power in Germany. They haven't been fully aligned year to year largely due to limitations in the power grids.

Most people are aware that war and disruption in the supply of oil from the Middle East will drive up oil prices and thus also the prices they pay for petrol (gasoline). But many people in Norway and Sweden were both surprised and angry that rocketing natural gas prices in Europe due to the war in Ukraine were driving up their power bills to previously unseen levels.

The average power price in Stockholm during 2022 was EUR 129/MWh. That is 3.6 times higher than the 20-year average to 2020, but only 55 per cent of the 2022 average in Germany, which was EUR 234/MWh. Stockholm averaged 95 per cent of German power prices over the 20 years to 2020. And in 2023 the Stockholm price vs Germany is likely to move as low as 50 per cent.

Average spot power prices



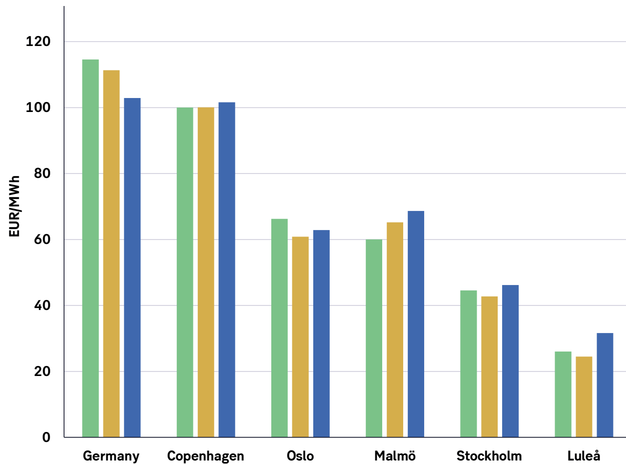
Source: Bloomberg

The chart shows average spot power prices from 2001 to 2020 and average prices in 2021, 2022 and 2023 in Germany, Oslo and Stockholm.

Supply and demand in the electricity market

A significant power surplus in Scandinavia has developed over the past couple of years. That is the reason for the unusually large differences in power prices in Stockholm vs Germany during 2022 and 2023. More renewable electricity from wind farms, new supply from the Finnish nuclear reactor Olkiluoto 3 (1600 MW or about 12 TWh/yr) and plenty of precipitation and hydroelectric power production help explain this. Power demand in Scandinavia has also fallen due to high prices. Altogether this has led to a surplus of power in Scandinavia of a magnitude which the power grid connecting to Germany cannot handle, thus pushing down Scandinavian power prices vs Germany to abnormally low percentages.

Forward power prices by location and year as of November 10, 2023



Source: Bloomberg

Fortunately, forward power market prices indicate that many locations in Scandinavia will remain abnormally and deeply discounted to Germany over the next three years. Stockholm prices are expected to be only 35-40 per cent of those in Germany. This is solely due to limited grid capacity and an overall power surplus in Scandinavia.

> *Germany is the heart of the European power market, and what happens there has ripple effects to most power markets in Europe."*

One thing which is apparent here is that the further away from Germany you get, the larger is the difference. This reflects the increasing cumulative constraints in grid capacities the longer the distance.

But if there hadn't been a power surplus in Scandinavia, then prices in 2022, 2023 and during the next three years would probably have stayed close to German power prices, both on a spot and a forward basis. Senior analyst Eylert Ellefsen at Montel Energy estimates that Scandinavia will export 55 TWh of power in 2023. Note, however, that there can be huge variations in the Scandinavian hydroelectric system, where production can vary ±30 TWh between dry and wet years. So, if we were to see a dry and cold year in Scandinavia over the next few years, the power surplus would shrink significantly with the result that power prices would race towards German levels.

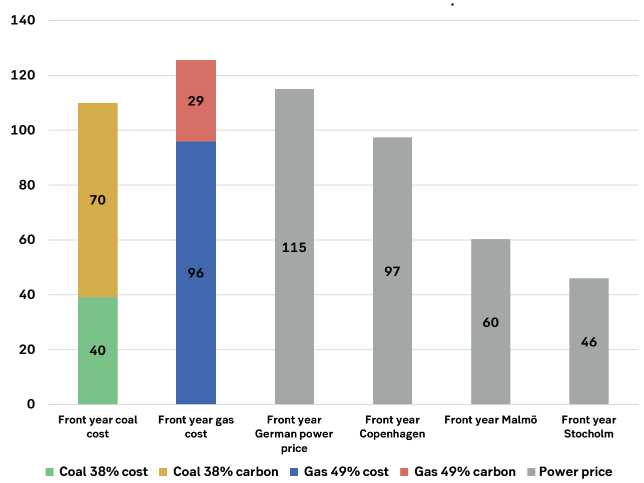
Also worth noting is that the southern part of Norway is projected to move into deficit as early as 2026, which would rapidly help to shift power towards German price levels.

What currently seems like very favourable power prices could suddenly evaporate, with prices rapidly climbing towards German levels if the weather gods in Scandinavia turn against us. Also, to ensure that prices in Scandinavia remain significantly subdued versus Germany we need to keep building more supply, because power demand is projected to rise significantly as we continue our path towards an electrified, non-fossil fuel-based society.

The effect of natural gas

We can of course hope that the prices of coal and natural gas will come down over time. Coal prices may move a little lower, but they have a relatively low impact on costs, so it won't matter all that much. A good rule of thumb is that to make one unit of power, you need two units of natural gas plus 0.3 units of CO_2. So, if the price of natural gas is EUR 50/MWh and the price of CO_2 is EUR 80/tonne, then the cost of power made from natural gas is roughly EUR 127/MWh.

German power prices and costs in EUR/MWh

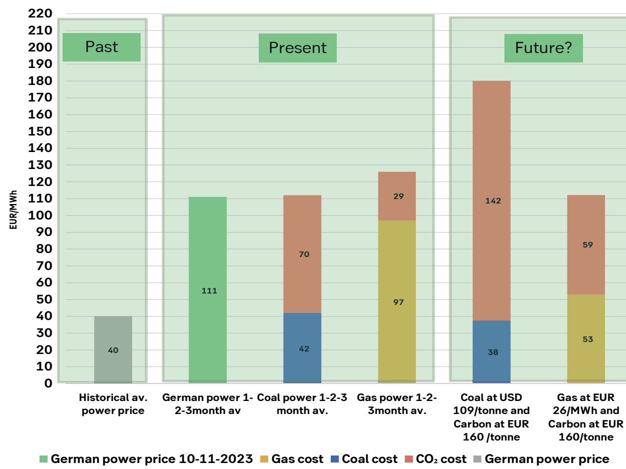


Source: Bloomberg, SEB

The chart shows how the pricing of German electricity for 2024 is related to the cost of coal and carbon dioxide, as well as gas and carbon dioxide.

Natural gas prices are still very high: close to EUR 50/MWh versus a nominal average of EUR 20/MWh from 2008-2020, which is equivalent to EUR 26/MWh in today's money. Our expectation is that natural gas prices will indeed move down towards that level over time. The average price of natural gas so far this year is already down to EUR 41/MWh versus the record average of EUR 132/MWh in 2022. The cost pressure from German power prices towards Scandinavian power prices with respect to the cost of natural gas is thus likely to fade over time, and it already has started to do so. The price of CO_2, however, is instead likely to rise even higher.

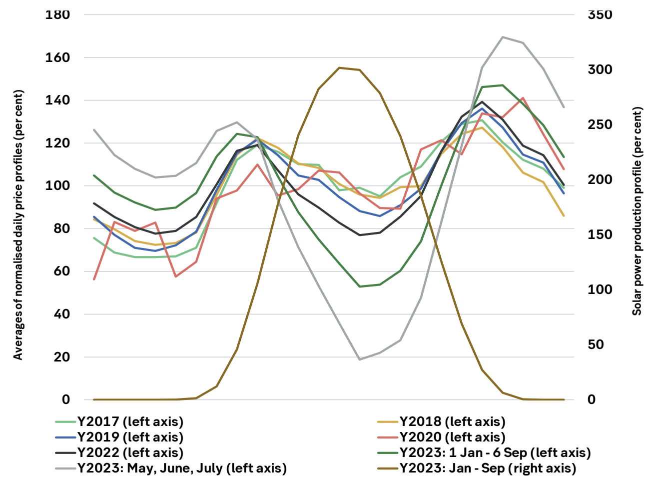
Potential power price situation in Germany



Source: Bloomberg, SEB

The chart shows a potential scenario for the power price situation in Germany some time over the next five years in terms of past, present and future.

Hourly price profiles for German power supply



Source: Bloomberg, SEB

The brown curve shows the hour-by-hour solar power production profile during January to September 2023.

What will happen in the future?

General expectations are that CO_2 prices in the EU will move towards EUR 150-200/tonne as we approach 2030. This will make coal-fired power generation completely unprofitable unless it gets a large premium for stability purposes. But even if natural gas prices fall back to EUR 26/MWh, the higher CO_2 price will still place the marginal cost of German power based on natural gas at around EUR 110/MWh. This is close to where German power is priced for 2024, given a combination of high natural gas prices and a CO_2 price of around EUR 80/tonne.

However, the hope is that increasing supplies of solar, wind and nuclear power will gradually reduce the role of natural gas in the European power supply. Prices during fewer and fewer hours in the year will then be set by natural gas power plants. Those hours may, however, be extremely costly since they have to carry the whole year's worth of capital and maintenance costs. Natural gas and coal would nevertheless still play a diminishing role as setters of the average power price for the whole year. The result could thus be that power prices in central Europe would move down towards EUR 60-80/MWh over time, even if CO_2 prices move towards EUR 150-200/tonne or higher.

One complicating factor is that the exponential growth in solar power now has started to undercut its own profitability, both for existing and new solar power supply. The consequence is that the growth in solar power supply may start to slow down for a while. The medicine for that slowdown is of course a temporary shift in focus from building more supply to instead building more power cables, as well as installing lots of grid batteries so that surplus solar power from midday can be shifted to evening, night, and morning hours. New supply of solar power can then accelerate yet again. The energy transition is perhaps more difficult than we had thought and hoped, but it won't stop, and we do have all the technological ingredients needed to make it happen.

The catastrophic events in Ukraine since 2022 have changed a lot of perspectives in Europe. Eastern Europe can no longer depend on cheap natural gas from Russia. Nor can the region rely on coal-fired power plants in a carbon-restricted European market with rising CO_2 prices. These countries are not confident that solar and wind power will give them the reliability and security of supply which their industries and consumers deserve.

As a result, more and more countries in Europe are signing up for new nuclear power plants to help decarbonise their economies by 2050. This is not just true of Eastern Europe. The same goes for Sweden, Norway (private initiative), France, Italy, the Netherlands, Belgium and the United Kingdom. Germany is still resisting and sticking to its farewell to nuclear power. But it is becoming increasingly clear that nuclear power is on its way to making a comeback – especially given our increasing understanding of the problems connected with building a new energy system solely based on solar and wind power.

Europe may not be able to build that many new nuclear power plants in the coming 10 years, but we could build a large number between now and 2050 if we really decide to do so.

International overview

Excerpt from the Nordic Outlook research report.
For the full report, see seb.se/nordicoutlookreport.

A troubled world continues to hope

The slowdown is continuing but looks different in different countries. The United States will see a soft landing after showing surprising resilience. The euro area economy is still fragile, while the outlook for China has stabilised. Due to weak demand and high interest rates, growth will remain anaemic. Geopolitical turmoil poses downside risks, but lower inflation, high employment and rising real wages provide hope. Key interest rates have peaked, and the Fed will begin its rate cutting cycle by mid-2024.

The Middle East war is adding to an already uncertain geopolitical situation, with further human suffering from a growing number of conflicts. The Hamas-Israel war is unfolding close to oil-producing countries, contributing to economic volatility. It also risks decreasing the world's financial and military support for Ukraine. However, our main scenario is that the economic consequences will be limited. Inflation trends remain perhaps the most decisive factor for economic activity, interest rates, the stock market and asset prices. Tighter financial conditions during the third quarter, including higher long-term bond yields, will reinforce the impact of already high key rates and help central banks cool their economies and ease inflationary pressures. But they are also leading to greater uncertainty about how much tightening these economies – and the financial system – can handle.

Minor revisions in a divergent world

The latest statistics indicate that the main scenario in our August update remains valid: a deep economic slump can be avoided. China's growth outlook has improved somewhat, and emerging market economies are generally holding up relatively well. There is a clear slowdown in the 38 mainly affluent OECD countries, but with major differences between countries and sectors; the US is slowing, and the euro area continues to stagnate. High interest rates and prices are weighing on consumption and housing construction. According to indicators, businesses have a gloomy view of the future and production growth is weak. Questions about peak interest rates and the pace of inflation deceleration are beginning to be answered. Our forecast revisions are relatively small.

Global GDP growth, %

Market	2022	2023	2024	2025
United States	1.9	2.3	1.1	1.8
Japan	1.0	1.8	1.2	0.9
Germany	1.8	-0.2	0.5	2.0
China	3.0	5.2	4.6	4.5
United Kingdom	4.3	0.4	0.5	1.7
Euro area	3.4	0.5	0.7	2.0
Nordic countries	2.7	0.2	0.5	2.3
Sweden	2.6	-1.0	-0.4	2.5
Baltic countries	2.0	-0.7	1.5	2.9
OECD	2.9	1.6	1.2	2.0
Emerging markets	3.7	4.1	4.0	4.1
World, PPP*	**3.3**	**3.0**	**2.8**	**3.2**

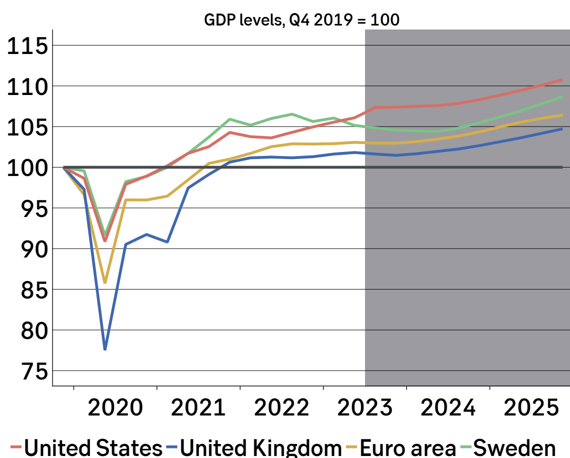
Source: SEB Nordic Outlook

*PPP=Purchasing power parities. The table shows forecasts of real economic growth in line with our main scenario

Global growth of 3 per cent for 3 years

US growth has again surprised on the upside, but a deceleration will occur around the turn of the year. The euro area, where growth rates are already around zero, will grow by about 0.5 per cent annually in 2023-2024. The next few quarters will be anaemic, but the US and the euro area will avoid a recession. Global GDP will increase by about 3 per cent annually in 2023-2025, which is relatively weak in a historical perspective. Although growth will be moderate for a while longer, the impact of rapid rate hikes and the inflation shock has so far been surprisingly limited. It remains unclear whether we have underestimated the headwinds and the lag with which monetary policy operates.

Soft landing



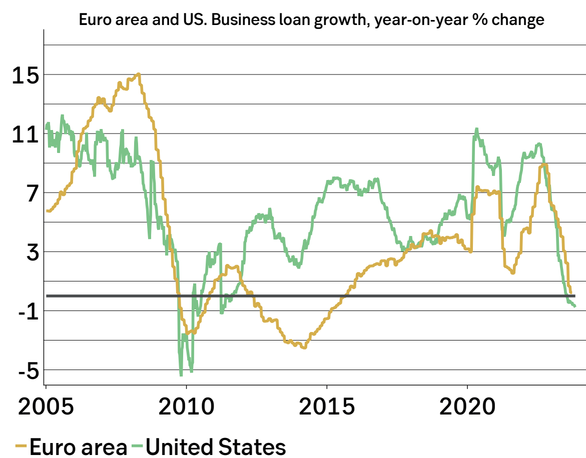
Source: Macrobond , SEB

Growth is changing from big fluctuations to small movements. Swedish growth is slowing the most, after rising fastest before.

Monetary tightening in the third quarter

There was an unexpectedly sharp tightening of financial conditions during Q3 2023. For example, households, businesses and governments face significantly higher real interest rates, while asset values have been squeezed and the US dollar's strength has persisted. Federal Reserve calculations show that the real yield on US 10-year Treasury notes rose by 0.7 percentage points in Q3 and kept rising in October to 2.1 per cent, the highest since autumn 2007.

Business loans stopped growing, likely to shrink



Source: Federal Reserve, ECB (European Central Bank), Macrobond, SEB

Weaker credit demand is not surprising, given higher interest rates and warnings of decelerating growth.

Credit demand continues to decrease

Business lending by banks has stalled in both the US and the euro area – mainly reflecting lower demand, rather than any inability or unwillingness to lend. This is a natural element of the monetary policy transmission mechanism during a rate hiking cycle. Both Fed and ECB loan surveys indicate that the demand for credit will continue to decline going forward. Nor are credit spread changes any cause for concern, despite the significant challenges facing commercial real estate operators.

Powerful monetary tightening effect

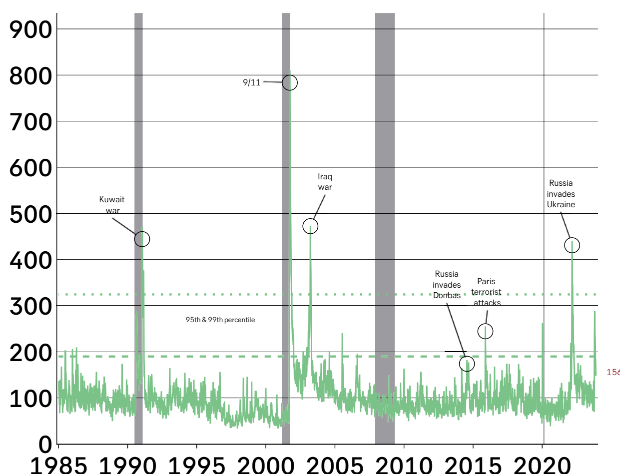
The phenomenon of powerful monetary tightening via financial conditions – and not only through changes in key rates – has occurred late in the central bank tightening cycle: GDP growth has already slowed, and inflationary pressures are easing. A strong labour market, large savings buffers from the pandemic and, in the US, less interest rate sensitivity due to long-term fixed interest mortgages, may explain household resilience. For businesses, well-filled order books from the pandemic years have contributed to a gentler slowdown. But the labour market now appears to be weakening, and US household savings are at low levels, since buffers are now being depleted.

There is thus reason to fear that the impact on the real economy and the financial system may be greater now than at the start of the tightening cycle. This suggests that central banks will refrain from new rate hikes, even though underlying inflation remains a bit above target, and instead increase their preparedness for monetary easing in 2024.

A situation that is difficult to communicate

Most central banks find themselves in a complicated verbal balancing act. For example, Fed Chair Jerome Powell caused strong market reactions – falling bond yields, a weaker dollar and rising stock markets – when he commented on the November 1 policy decision. Central banks are well aware that confirming a peak in key interest rates feeds expectations of future cuts, while painful memories of inflation forecasting errors earlier in the cycle call for caution. If near-term financial conditions ease too much, we can expect more hawkish central bank communication. Meanwhile most central banks also appear somewhat confident that the rate hikes they have already implemented have not yet had a full tightening effect, which is currently decreasing the need for new rate hikes.

Geopolitical risk index



Source: Matteo Iacoviello, Macrobond, SEB

The tragic conflicts in Ukraine and the Middle East are also fuelling greater uncertainty about the economy, but we expect them to have only limited effects.

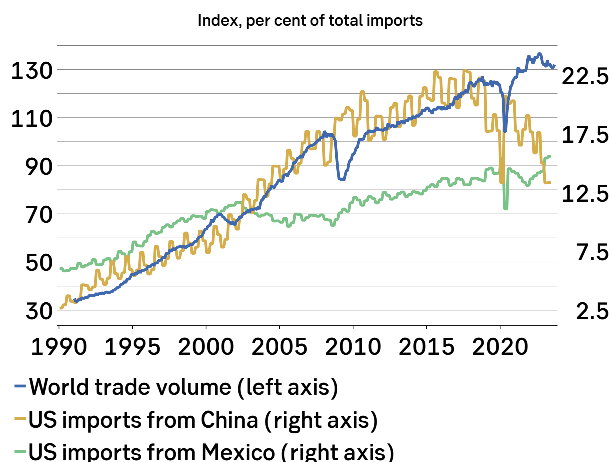
Increased geopolitical tensions

Global tensions have intensified, and security policy crises have become more frequent. This introduces complicated and economically hard-to-interpret – often binary – issues into the analysis, which requires humility in making both short- and long-term assessments. While human suffering from war is indisputable and widespread, the economic consequences are difficult to analyse and are necessarily based on uncertain assumptions. We continue to assume that the war in Ukraine will be prolonged but will not escalate in a way that have new major impacts on commodity prices. We have also concluded that the Middle East conflict will not spread further, with major consequences for energy and other commodity prices.

A more divided world

Uncertainties about global cooperation, tariffs, trade barriers and climate issues affect the behaviour and plans of countries and businesses. This is in addition to other changes in the international environment, such as the need for inventory buffers and improved risk management following the pandemic. But the impact of such changes is hard to measure, and we rarely see rapid fluctuations in trade flows. Although the new geopolitical climate and greater demands on production reliability affect trade flows, the number of goods that are de facto restricted by the US and Europe, for example, is still relatively small. But one sign of changing trade flows is that US imports from Mexico have now overtaken those from China for the first time in 20 years (except for one quarter during the pandemic).

The US now imports more from Mexico than from China



Source: International Monetary Fund (IMF), Netherlands Bureau for Economic Policy Analysis (CPB), Macrobond, SEB

In a world moving from greater globalisation to fragmentation, trade flows are changing in favour of more nearby countries.

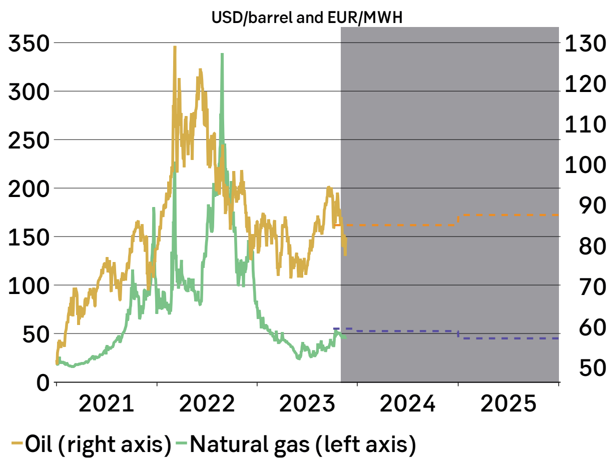
No Middle East escalation, according to oil prices

The price of oil, which rose from about USD 75 to over USD 95 per barrel in Q3, has now fallen to about USD 80/barrel, the same as at the beginning of 2023. This is despite the Middle East crisis. The price has been kept up due to production caps by Saudi Arabia, among others, and also because of strong demand for distilled products, causing refineries to operate at full capacity. Markets remain concerned that the Middle East conflict will spread, but after an initial price surge the oil market does not seem too nervous – reassured by Saudi reserve capacity and because other producers such as Venezuela are expected to boost output in the next few years.

Small energy price changes due to anaemic growth in 2024

The oil market expects weaker economic growth and oil demand, as well as a decline in the need for oil from the OPEC+ cartel as other producers ramp up production. Overall, this suggests lower oil prices, but we believe Saudi Arabia and Russia will continue to limit production in an effort to balance the market. Self-imposed restrictions such as current Saudi production of 9 million barrels/day will remain in place.

Energy prices



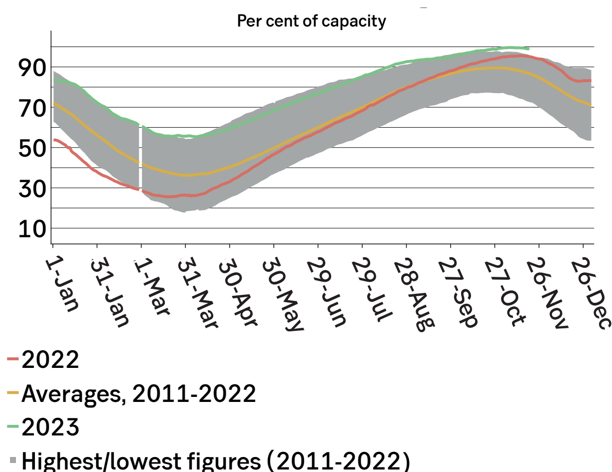
Source: Intercontinental Exchange (ICE), Macrobond, SEB

We expect stable energy prices, with production restrictions offsetting variations in demand.

Record-breaking European gas inventories

The liquefied natural gas market is important to Europe, since pipeline imports from Russia have fallen sharply. The price of gas is still twice as high as before Russia's attack on Ukraine. With lower gas use and increased imports, European reserves have reached record levels. Winter weather is always uncertain, and energy price-related problems are possible over the next few months. But the most likely scenario is that the region will manage the coming winter nicely. Our forecast for natural gas prices already includes a certain risk premium for the winter.

Record-full European natural gas reserves



Source: Gas Infrastructure Europe (GIE), Macrobond, SEB

Record gas reserves suggest that Europe will make it through this winter without major energy supply or price disruptions.

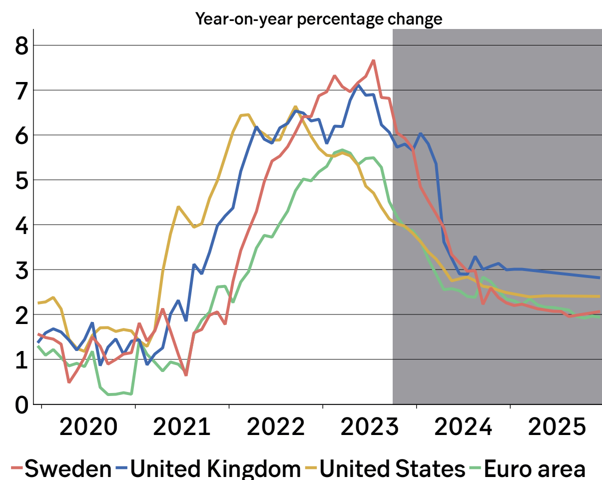
Falling prices, but varying dynamics

It is crucial to our forecast and outlook that inflation will continue falling towards 2 per cent. We are now approaching an inflation rate of just below 3 per cent in both the US and the euro area. However, core inflation – the most important metric for central banks – is about 1 percentage point higher than consumer price index (CPI) inflation. There will be a delayed impact from earlier rapid price and interest rate increases, for example affecting rents and wage demands. This has been singled out by central banks as the key to how large the remaining inflation problems will be. While base effects have a major impact on annual inflation, month-on-month or quarter-on-quarter inflation dynamics provide a better picture of underlying trends and are thus important in determining when key interest rates will be cut.

Inflation drivers are clearly slowing

Inflationary forces are now weakening, although various risks remain. Prices of internationally traded goods have fallen sharply. This applies primarily to commodities, but producer price index (PPI) statistics for input goods also show a clear decline. For consumer goods, PPI prices are just starting to fall in Europe. The energy situation looks relatively good compared to last year, but European electricity prices are still significantly higher than they were two or three years ago.

Core inflation falling, will reach targets by late 2025



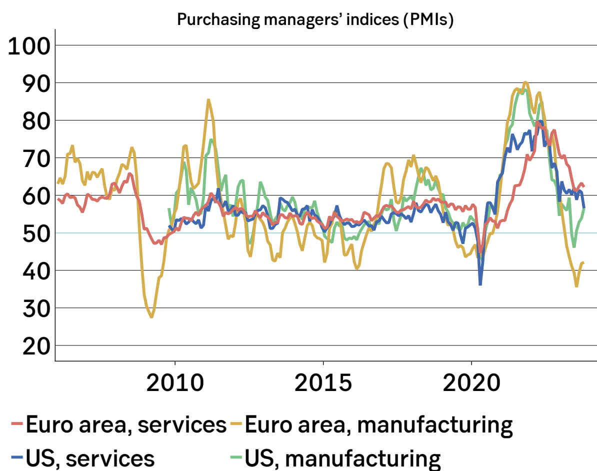
Source:Macrobond, SEB

Core inflation, which is the focus of central bank attention, will gradually fall towards target levels over the next two years.

Diverging price expectations

There are persistent differences in business price expectations between economic sectors. The manufacturing sector believes that prices will fall, while service businesses expect them to rise, though to a lesser extent than before. A continued upturn in service prices, great uncertainty about employee demands for restoration of earlier real wages – and perhaps high rent increases – are the biggest risks from an inflation perspective. One example of lingering wage risks was recently seen in the US, where an auto workers' strike ended with a 25 per cent pay increase over a 4+ year period.

Perception of input prices

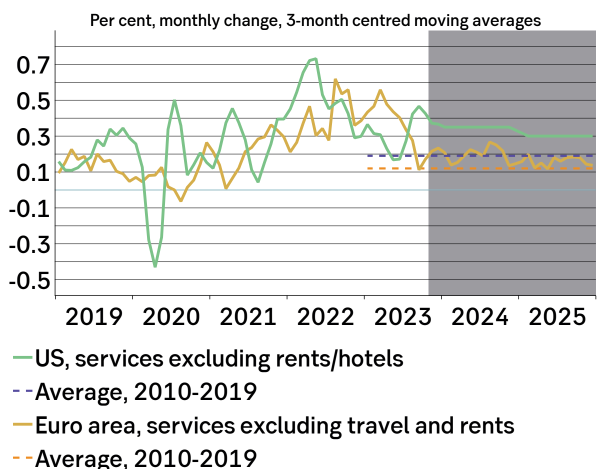


Business price expectations have fallen, which is especially clear for the manufacturing sector and in the euro area.

Differences between the US and Europe

In recent months, the inflation picture has begun to diverge a bit more. We have been seeing new trends for some time now. The US economy remains resilient. In the UK, wages are rising rapidly. In both cases, this may fuel inflation. In the euro area, data show that price pressures have eased significantly over the past six months, and this autumn we have seen broad-based downside surprises for service prices. But in the US, the slowdown is primarily among goods prices, while service prices are still rising faster than normally. Price increases in the euro area are still high compared to recent decades, but the slowdown has been much faster than we expected and contrasts a bit with the elevated price expectations in sentiment surveys.

Differences in US and euro area price momentum



Current price increases have slowed surprisingly fast in Europe, while service price increases have remained high in the US.

Sweden stands out to some extent

In the short term, Swedish inflation statistics have stood out as somewhat on the high side. Among other things, the impact of exchange rates appears to be stronger than we previously estimated. On the margin, this puts greater pressure on the Riksbank, although recent inflation developments in the euro area should eventually lead to positive surprises in Sweden as well.

Despite differences: similar slowdown ahead

Although economies and regions are showing somewhat more divergent inflation drivers, we are maintaining our forecast that the economic slowdown will look quite similar. Growth in the OECD economies will decelerate, and once labour markets cool, wage pressures will subside. Well-functioning supply chains will also help ease overall price pressures. But viewed over our forecast period, we still believe that the cost situation will be higher than in the decades before the pandemic, which is why core inflation will not fall below 2 per cent.

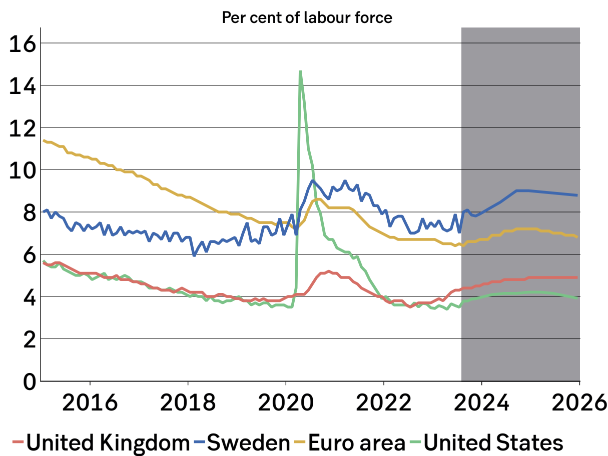
Can inflation dynamics change the order of rate cuts?

A fall in demand should presumably ease price pressures. Due to uncertainty about the impact of commodity prices on consumer prices, the role of expectations and – above all – next spring's wage negotiations, we do not wish to lower our euro area inflation forecast too much. In the current situation, the costs to the European Central Bank and its peers of declaring victory over inflation too early would still weigh heavily compared with waiting further. Because a second wave of strong inflation cannot be completely ruled out, the ECB is delaying such a declaration. But although the battle has not been won, our inflation forecast for the euro area includes some downside risks. If they materialise at the same time as US growth continues to surprise on the upside, we may see a situation in which the ECB cuts its key rate earlier than the Fed. Market pricing has shifted in that direction over the past few weeks, indicating that the ECB will begin its cuts first.

A few quarters of weak growth ahead

The economic slowdown due to higher interest rates and elevated prices is occurring at different rates and different times. The factors that have pulled down euro area growth so far – consumption and housing construction – will remain sluggish for a few more quarters, and American household consumption will also slow as the labour market cools. Household pandemic buffers and well-filled company order books will still provide some support for growth, but momentum is gradually diminishing. Because of high prices, households need to pay more for smaller volume. This has been reflected in historically large differences between consumption in nominal and real terms. Now that real wages have begun to rise again, consumption will enjoy increased support, but the scope for a more substantial acceleration is limited because the savings ratio has already fallen. We are also seeing subdued business sentiment indicators and declining industrial production. However, high interest rates have mainly hurt residential investments, while other capital spending is getting a boost from parts of the economy that are doing better, such as the green transition and energy and defence investments. Public investment programmes launched during the pandemic also provide some continued support.

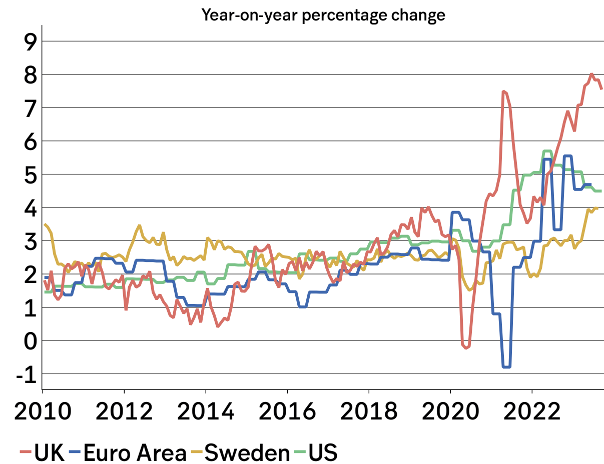
Unemployment will climb, but only moderately



Source: Macrobond, SEB

Labour markets have been surprisingly strong but are now cooling, though undramatically.

Varying wage and salary growth



Source: U.S. Bureau of Labor Statistics (BLS), Eurostat, U.K. Office for National Statistics (ONS), Macrobond, SEB

Pay has recently climbed faster, but with geographic variations – largely dependent on differing wage formation systems.

Strong labour markets are weakening

Job growth has continued to surprise on the upside and labour markets have shown resilience, with unemployment remaining low in many places. But there are signs in both the US and Europe that the tide is turning. Among other things, the number of job vacancies is falling, layoffs are increasing and job growth is slowing. Past labour shortages may have contributed to hoarding behaviour by employers. In a weaker labour market, this behaviour may be replaced by its opposite as staff turnover slows again. The continued resilience of service sectors is an important explanation for the strength we have seen so far, but also for the fact that we now expect a slowdown in the labour market as households are forced to cut spending. In some places, including such European countries as Germany and Sweden, unemployment is now rising, but the increase will still be moderate. In the US, too, a cautious upturn has begun from very low levels, but because of a positive trend in the labour supply, this can take place without a reduction in employment. Wage growth is also moving in different directions, depending on how wage formation works in each country.

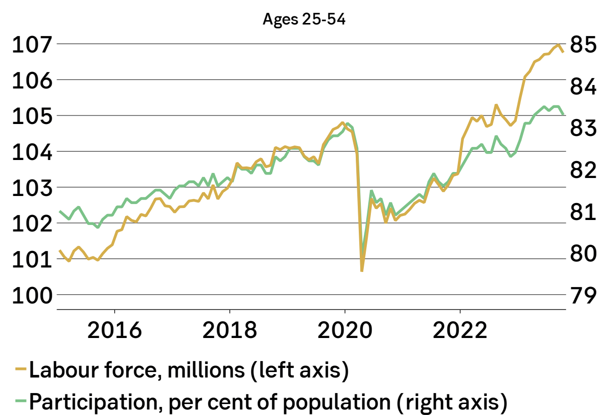
The US is finally slowing down

Growth remained surprisingly strong through the third quarter of this year, but there are many indications of a slowdown ahead. Weaker real income growth will dampen consumption, while the labour market will weaken moderately. Aside from higher interest rates, which are hurting residential and other investments, businesses are decreasingly willing to make investments. The labour market is moving towards a better balance. The rate of pay increases is slowing despite an increase in employment. This positive structural indicator is contributing to our belief that both wage pressures and inflation can be normalised without the US economy entering a recession.

Euro area mixed as manufacturing faces the most headwinds

Euro area growth has averaged around zero for four straight quarters, and GDP fell by 0.1 per cent in Q3 2023. Germany, which has been hard hit by the energy crisis and is more exposed to a cyclical downturn in global manufacturing, is the weakest; GDP has fallen in three of the past four quarters. The outlook is generally weak, but falling inflation and more stable (though relatively high) energy prices are providing some light at the end of the tunnel.

US: More labour force participation strengthens the supply side



Source: U.S. Bureau of Labor Statistics (BLS), Macrobond, SEB

The expected upturn in US unemployment will be more attributable to an increase in the number of job seekers than to a decline in employment. This will help sustain growth.

Mild downturn, moderate recovery in 2024-2025

Our soft-landing scenario, which implies that the US and the euro area will avoid a deep recession, looks set to materialise. Yet it is now being challenged by historical links between inverted yield curves and rising US unemployment, two factors that both usually lead to a recession. But although history suggests there will be no soft landing, the world is far from normal – in light of the events of recent years: the COVID-19 pandemic, an interest rate reversal, volatile energy prices and global tensions. In addition, because the supply side in the US seems to respond well to high demand for labour, with a rising employment rate, the increase in unemployment is mainly due to more people looking for work, rather than a drop in employment. US productivity has also improved recently. Although we foresee an acceleration towards the end of our forecast horizon, growth must be described as moderate and weaker than in a normal recovery cycle. The supply side is constrained, household incomes are weak, and fiscal policy lacks muscle due to already high debt. Monetary policy will be more cautious once rate cuts get under way, and because of an already high level of employment, the amount of idle resources is limited. On the positive side are the above-mentioned supply factors; the labour supply is improving in many countries and productivity seems to be picking up.

Chinese growth has hit bottom; challenges remain

China's economy is not on completely solid ground after last spring's growth worries and the problems of the real estate sector. Third quarter growth was an upside surprise, which offers some hope, but meanwhile many other statistics this autumn have surprised on the downside. Although growth has stabilised and new fiscal stimulus measures have been unveiled, the outlook is characterised by several weaknesses. Households are holding back on spending, and investment is weak as real estate sector troubles reduce residential investment. Weak local and regional government finances are also holding back infrastructure investments. As economic growth slows in affluent countries, China's exports – a part of the economy that has been a driving force since the pandemic – are also facing headwinds. In addition, structural factors will push down growth in the long term. China lacks a strong welfare state, and fiscal policymakers provide more supply-side than demand-related stimulus, which contributes to caution among households. Investments are also being hampered by the uncertain institutional and geopolitical environment. Regional authorities with high debt burdens are facing tough refinancing challenges and difficulties in scaling up investments. Overall, this points to slower growth ahead and thus a smaller Chinese contribution to global GDP growth.

GDP growth, BRIC countries and EM sphere

Year-on-year percentage change	2022	2023	2024	2025
China	3.0	5.2	4.6	4.5
India	7.2	6.5	6.3	6.2
Brazil	2.9	2.9	1.8	2.0
Russia	-2.1	2.0	1.5	1.3
EM economies, total	3.7	4.1	4.0	4.1

Source: IMF, SEB

Varying prospects for EM economies

As we noted in our latest *Emerging Markets Explorer,* it looks as if the growth downturn has bottomed out in many EM economies, except for India, which has continued to perform strongly. There, but also in Brazil, consumer confidence has shifted into higher gear. However, the picture remains divided. India is supported by both domestic and external factors that make our growth forecast look a little brighter than for many other countries. India's favourable geopolitical position has led to an improved climate for foreign direct investment. High inflation remains a challenge, although it has fallen by 10-20 percentage points since the peak after Russia's invasion of Ukraine. Despite above-target inflation, the interest rate cutting cycle has started in several countries, such as Brazil, Poland and Hungary. In some cases, this is being driven by a combination of lower inflation expectations and, as inflation has fallen, higher real interest rates. But financial conditions in EM countries may become more fragile than the current situation indicates. Central banks are cutting key rates at a time of uncertainty. Rapid financial fluctuations – driven by geopolitical turmoil and volatile inflation outcomes, especially in the US and the euro area – could put pressure on EM financial assets. Our base scenario is thus that inflation forecasts will allow central banks to cut rates at a moderate pace, but we believe that lower rates will leave EM economies more vulnerable to external shocks.

Global tensions increase downside risks

In the August issue of *Nordic Outlook,* our risk picture was neutral. Meanwhile we predicted that the divergence from our main scenario would be greater in a negative scenario than in a positive one. The main reason is that we foresee limited upside potential, given a low level of unemployment to begin with. This is true even though we have seen a positive trend in the US and elsewhere, with rising labour force participation. Due to further intensification of global tensions and increased uncertainty about how economies will cope with this autumn's tighter financial conditions, we once again foresee somewhat larger downside risks to our forecast than upside risks.

Various scenarios for the OECD countries

GDP growth, per cent	2023	2024	2025
Main scenario	1.6	1.2	2.0
Negative scenario	1.5	-0.6	1.3
Positive scenario	1.6	2.5	2.4

Source: SEB

Geopolitics will lead to downside risks

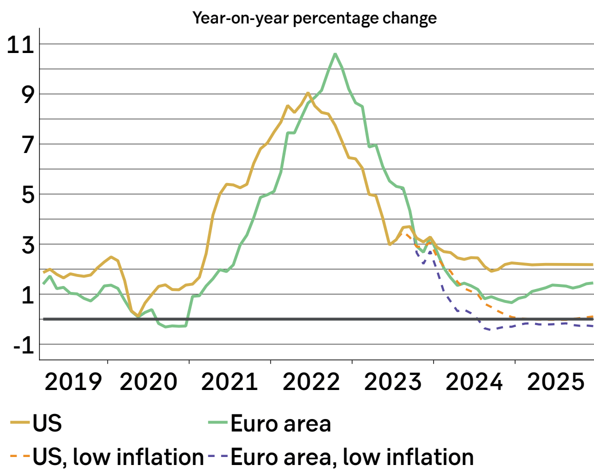
When we interpret economic data from the past few months, developments have been largely in line with our expectations, which suggests a symmetric risk picture. But just as there was uncertainty due to financial stress last spring, when several regional US banks failed, we are now seeing increased uncertainty because of geopolitical developments and the risk that the fighting between Israel and Hamas will spread. Russia's invasion of Ukraine has reminded us of the extent of the economic consequences when energy supply is disrupted.

It is also still difficult to assess when and how large the full impact of earlier interest rate hikes will be, how much savings buffers households actually have left and how severe the impact on today's extra late-cyclical tightening due to rising long-term bond yields will be. Yields are increasing at the same time as inflation is on its way down, which has an extra tightening effect, since real interest rates will increase more than if we only look at nominal interest rates.

Inflation will fall faster and growth will accelerate

A faster downturn in inflation, combined with a slowdown in the rate of pay increases that is reassuring to central banks, may persuade these banks to cut key rates sooner than we expect. It does not require especially large changes in our forecast assumptions for the inflation rate to fall towards 0-1 instead of 2 per cent. Perhaps we are too cautious about factoring in the favourable inflation signals we have recently seen in the euro area. Or prices in general may be pushed down more in the future. If, for example, we assume that one third of the upturn in goods and food prices during the past few years and rents in the US are reversed, our inflation forecast points clearly lower, with increased real purchasing power and lower interest rates as a consequence.

Low-inflation scenarios



Source: Macrobond, SEB

If we assume that some of the prices that have climbed the most until now will fall slightly, inflation may turn out to be lower than predicted.

Sweden the weakest in the Nordic region

Denmark and Norway have shown more resilience than Sweden, where GDP has been on a downward trend since the end of last year. The driving forces are similar, in line with the global pattern, but with different intensities. Swedish GDP will decline in 2023 and 2024 as household consumption falls and residential investments collapse. Norwegian growth will be sustained by strong capital spending in the oil sector, while households will only gradually increase their consumption in 2024-2025. Underlying inflation will fall slowly amid persistently high wage pressures. In both Sweden and Norway, weak currencies will continue to generate inflationary impulses.

Danish GDP will be resilient, since household confidence has returned and inflation has fallen below 1 per cent, which will give an extra boost to real incomes. Residential investments are falling, and there is a risk that home prices will fall again as sales volume has declined, due to tax changes that have postponed transactions until early 2024. The government's change in fiscal policy will also provide a bit more support than we had previously expected.

GDP growth, Nordic countries

Year-on-year percentage change	2022	2023	2024	2025
Sweden	2.6	-1.0	-0.4	2.5
Norway	3.3	1.6	0.8	1.5
Denmark	2.7	1.1	1.5	3.0
Finland	1.6	-0.1	0.5	1.8
Nordic countries	2.7	0.2	0.5	2.3

Source: IMF, SEB

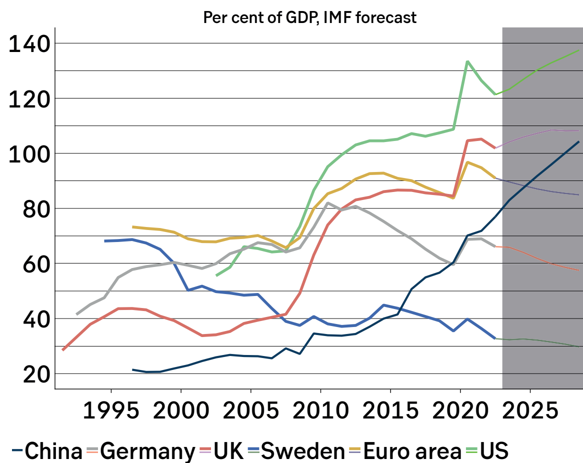
Real wages and lower interest rates will provide support

In all of the Nordic countries, growth will be supported by improved real wages and lower interest rates in 2024, and even more so in 2025. Sweden's Riksbank is hesitant about changing its policy rate, but by a narrow margin we believe that it will choose to leave the rate unchanged at 4.00 per cent in November, cut it by 50 basis points in 2024 and by a further 100 bps in 2025. Norges Bank will probably hike its key rate by 25 bps to 4.50 per cent in December, but this is far from certain. Due to surprisingly low inflation, the Norwegian rate hike may not take place. Partly due to uncertainty about next spring's national wage negotiations, Norges Bank will delay its first rate cut until mid-2024.

Fiscal policy both hampering and helping growth

We expect largely neutral fiscal policies over the next couple of years, despite the slowdown in economic growth. The main reasons are large government deficits and debts as well as increased market nervousness about future debt issue volumes. This is on top of the problem of inflation; politicians want to be careful not to create more inflation-drivers and thus need to hike key rates further. The focus of market attention has recently been on the US. In addition to large deficits and high debt, it is hard to see how politicians can agree on a plan for how to manage them. In the EU, a review of the fiscal policy framework is currently underway. The rules of the EU's Stability and Growth Pact were paused during the pandemic until the end of 2023. Hopefully, EU member states will be able to agree on a new legislative proposal before the end of the year, otherwise the old rules will enter into force. Whether they reach agreement or not, the EU countries will need more budgetary discipline in the next few years.

Worryingly high public sector debt in many countries



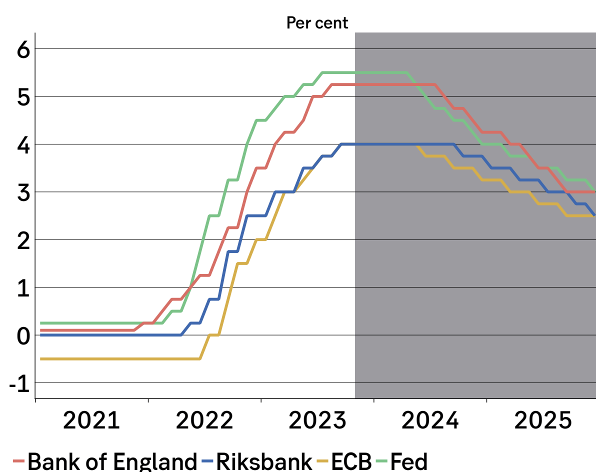
Source: International Monetary Fund (IMF), Macrobond, SEB

High government debt in many countries as well as higher interest rates limit the scope for stimulus during the slowdown.

Some could do more

We believe that the inflation risk from a more supportive fiscal policy is somewhat exaggerated – at least in countries with low debt and with growth problems, such as Sweden and Germany. These countries are also unlikely to risk anything from a confidence perspective, given a relatively low level of public debt to begin with. In most countries, fiscal policy will be broadly neutral over the next couple of years. They will save their small manoeuvring room to deal with shocks that are not in our main scenario or unavoidable expenditures related to security policy, energy and the environment. A more neutral policy helps central banks in their fight against inflation, but at the same time it hampers growth, which could use a shot in the arm.

Record-fast hiking cycle is ending



Source: Macrobond, SEB

We expect that after pausing for a couple of quarters, central banks will start cutting their key rates around next summer.

Pause in key rate hikes, first Fed cut in May

Following rate hikes at practically every policy meeting since early or mid-2022, the key rate has been left unchanged twice in a row by the Fed and at the most recent meeting of the ECB. It is clear, though to varying degrees, that interest rate hikes are having an impact on the economy. The inflation rate has more than halved. Central banks have also recently been helped by higher long-term yields and tighter financial conditions. This is one of the reasons why we believe interest rates have peaked for most central banks, including the Fed, the ECB and the Riksbank. Norges Bank and the Bank of England, which face somewhat more persistent inflation problems, will probably raise their rates one more time.

Central bank key interest rates, % at year-end

	Nov 9	2023	2024	2025
US Federal Reserve	5.50	5.50	4.00	3.00
ECB (deposit rate)	4.00	4.00	3.25	2.50
Bank of England	5.25	5.25	4.50	3.00
Riksbank (Sweden)	4.00	4.00	3.50	2.50
Norges Bank (Norway)	4.25	4.50	4.25	3.50

Source: Central banks, SEB

Hawkish to be on the safe side

While awaiting more information on the economy and inflation, central bank rhetoric continues to lean towards the hawkish side for various reasons. With the inflation shock and subsequent monetary policy reversal still fresh in mind, central banks do not want to underestimate inflation again. The tightening of financial conditions is helping them, however.

Central banks and deficits determine long yields

Long-term bond yields are a focus of market attention, after sizeable increases this autumn to nearly 5 per cent for 10-year US Treasuries followed by a decline to about 4.60 per cent in November, after Fed and ECB interest rate announcements were interpreted as marking the peak of key interest rates. Several driving forces are in motion. One explanation is monetary policy and key rate expectations. This autumn the market paid closer attention to the central bank mantra "higher for longer". But since then, expectations that short-term interest rates will not go any higher have pushed long yields back down. This argument is also connected to economic activity, since we believe that central banks now view their tightening efforts as sufficient to achieve the slowdown required for inflation targets to be within reach.

Supply, maturity premiums and real interest rates

But other driving forces have also had an impact. For some time, the bond market has been worried about high public sector debt and large bond issuance volumes when many borrowers must compete for the available capital. In this context the primary focus has been on the US, where – aside from large federal deficits – the future inability of the political system to manage them is another uncertainty factor.

Demand for US Treasuries will also fall as the Fed and the People's Bank of China reduce their holdings, and Japanese investment capital may return home as Japan's long-term government bond yields have now begun to rise towards 1 per cent. In addition, demand for capital may increase more generally due to investment needs in infrastructure, energy and the green transition. Other drivers are the maturity premium, which has been negative during the period of quantitative easing (QE) but is now rising. The inflation risk premium may also have increased as inflation expectations have fallen and are more in line with targets. Before central banks verbally stop signalling that interest rates may be raised another notch – which will take a few months – long-term US and European yields will remain volatile and without a clear direction.

The US: Different forces pulling in different directions

Key interest rate cuts will be the main driver of lower US yields in 2024 and 2025. Weak public sector finances, continued large deficits and high borrowing requirements will work in the opposite direction and cause investors to demand a higher maturity premium. Overall, however, substantial key rate cuts will cause the 10-year US Treasury yield to fall to 4.00 per cent by the end of 2025.

10-year government bond yields, % at year-end

	Nov 9	2023	2024	2025
United States	4.61	4.80	4.30	4.00
Germany	2.70	2.75	2.60	2.50
Sweden	2.85	2.90	2.90	2.80
Norway	3.81	3.85	3.50	3.30

Source: Central banks, SEB

Limited downside potential in the euro area

One result of the ECB's earlier bond purchases is that government borrowing rates in the larger euro area countries are significantly depressed compared to the key interest rate. The impact of lower key rates during the second half of 2024 and continued bond sales by the ECB will largely cancel each other out, and the downside potential is limited, especially in Germany.

Sweden's yield spread against Germany is normalising

The National Debt Office will increase issuance volumes next year. Weaker central government finances and the recapitalisation of the Riksbank suggest larger bond issues. We also expect the Riksbank to increase the amount of bonds that it sells, thereby increasing quantitative tightening. The 10-year yield spread against Germany has widened, and this trend is expected to continue. Altogether, these factors mean that the Swedish 10-year yield will be essentially at today's level at the end of 2025.

USD strength will gradually fade by year-end

This autumn has been characterised by a strong dollar, driven by high US interest rates and bond yields as well as falling risk appetite – due to both high rates and the geopolitical situation. We are maintaining our view that USD strength will fade towards the end of this year. Several factors will come into play: (1) a weak seasonal pattern for the USD, (2) a strong seasonal pattern for risk appetite, (3) Fed signals that it has probably finished hiking the key rate, (4) EUR/USD positioning which now shows that speculative accounts have already bought a lot of USD during the autumn and are quite ready to reduce that position. However, we foresee the greatest potential for a weaker dollar and a higher EUR/USD exchange rate during 2024, when the Fed will be the first major central bank to move towards a cut. This means that our forecasts of US vs European interest rates/bond yields support an appreciation of the euro against the dollar, i.e. a higher EUR/USD rate, in 2024. In addition, the growth gaps in our forecasts for 2024 will narrow. According to the historical pattern, this will lead to less dollar support. As the Fed begins to signal rate cuts more clearly, falling market interest rates will rapidly improve financial conditions, which should lead to increased risk appetite and thus a stronger euro. But as indicated above, there are many uncertainties. For example, a faster decline in euro area inflation could persuade the ECB to cut its key rates before the Fed. In addition, there is still a risk of a hard landing in the US. We thus do not expect an aggressive movement in which the euro will strengthen sharply early in 2024, but we believe that an upward trend will still begin.

Exchange rates at year-end

	Nov 9	2023	2024	2025
EUR/USD	1.07	1.08	1.14	1.18
USD/JPY	151	148	135	128
EUR/GBP	0.87	0.89	0.93	0.94
EUR/SEK	11.62	11.60	11.25	10.95
EUR/NOK	11.91	11.85	11.30	10.95

Source: Bloomberg, SEB

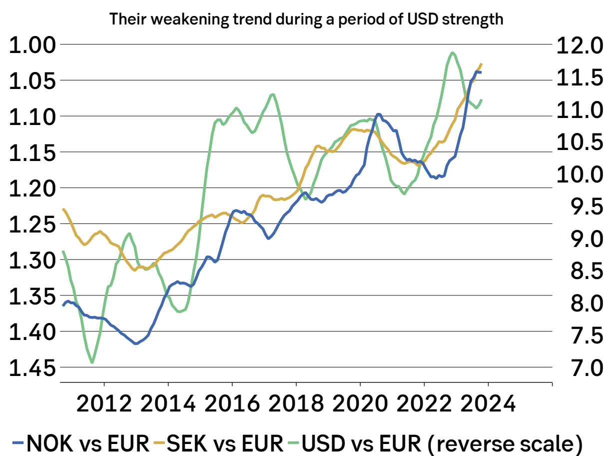
Support for the SEK and NOK mainly during 2024

The Nordic currencies have shown continued weaknesses this autumn. Anaemic risk appetite and continued expectations that interest rate hiking cycles will continue, or at least that interest rates will remain elevated for a long period, have not benefited countries and currencies with interest-sensitive households. We continue to believe that the global soft-landing environment and moves towards interest rate cuts by the Fed and the ECB during 2024 should be positive for both the Swedish and Norwegian currencies. The SEK should be able to appreciate as early as the end of 2023 – given its strong December seasonal pattern – while the NOK will probably have to wait until 2024 before it starts to gain ground. Positive drivers for the SEK and the NOK next year will be better global risk appetite and a general shift from rate hikes to rate cuts, which will remove negative pressure on currencies with interest-sensitive households.

Currency hedging may result in a stronger krona

As far as the Swedish krona is concerned, there is also a possibility that the Riksbank's hedging of its foreign exchange reserve, which involves krona purchases mainly during October 2023 to January-March 2024, may receive further support if more Swedish financial market actors choose to do the same (i.e. buy Swedish kronor). The probability of such a trend will increase the more the krona appreciates, and it could thus become self-perpetuating if critical levels for EUR/SEK and USD/SEK exchange rates are reached in early 2024. On the other hand, there is a risk of a significantly weaker krona if a hard landing occurs, and this may also be a partial explanation for why the krona has not appreciated so far. Historically, however, krona weakness has lasted for a relatively short time during hard landings (driven by falling risk appetite) and has then been replaced by krona strength. One example is that when the COVID-19 pandemic broke out, the SEK fell sharply but then appreciated and was the strongest G10 currency during the full year 2020.

SEK and NOK dependent on global environment



Source: Macrobond Financial AB, Macrobond, SEB

The Swedish krona and the Norwegian krone have been squeezed during the period of US dollar strength. We now expect a weaker USD, which will strength both currencies.

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This report was published on November 28, 2023.
Its contents are based on analysis and information available until November 27, 2023.

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