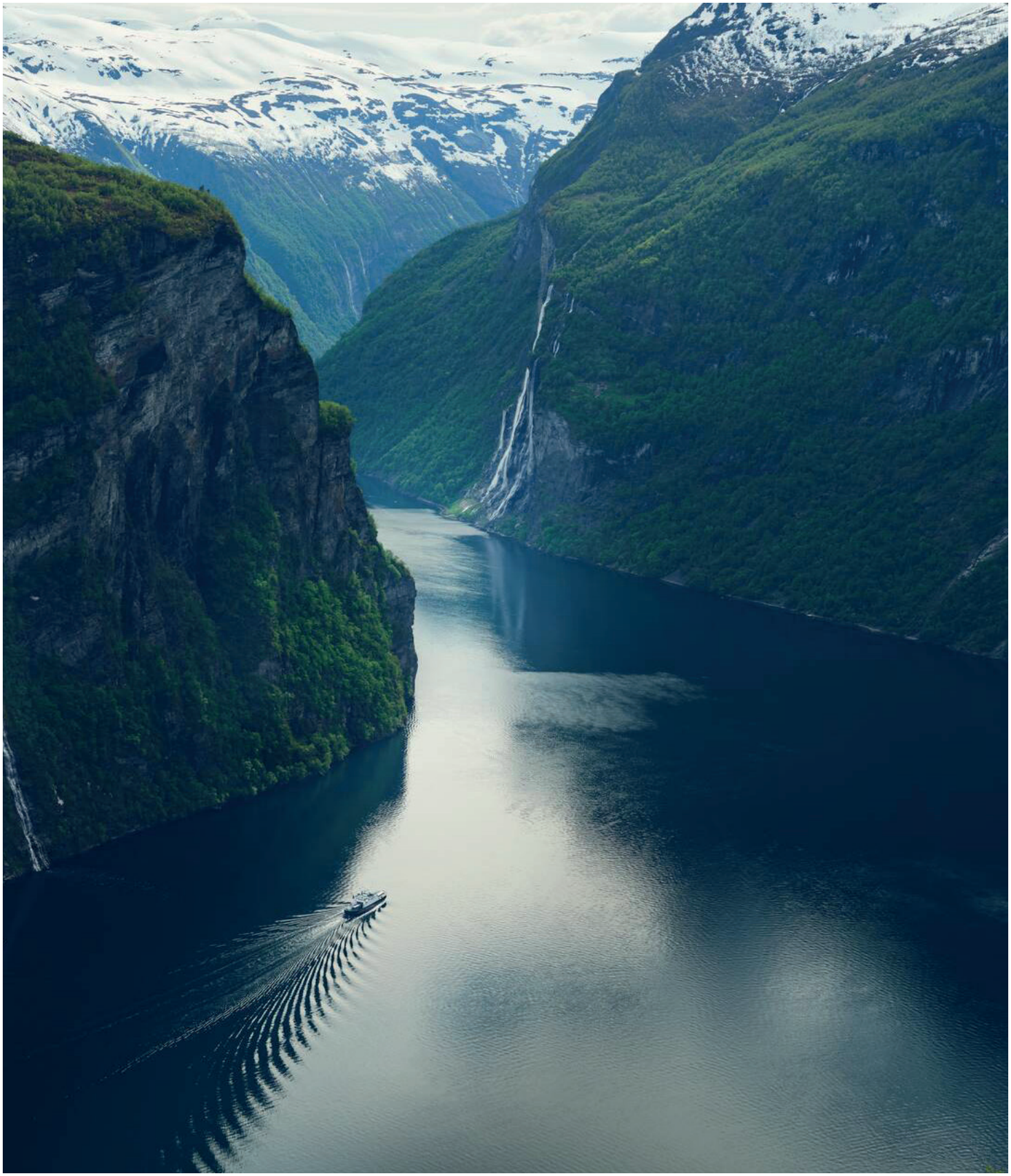

Investment Outlook

Inflation downturn will ease risk picture

February 2023

SEB

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February 2023

Introduction

This year began with positive stock markets, reflecting improved international economic conditions. Earlier concerns are fading, since falling inflation is reducing the pressure on central banks to keep tightening monetary policies. The ongoing energy crisis has also been managed better than expected, while China's reopening will make a solid contribution to global growth during 2023. In our main scenario, the coming recession will be mild – with growth around zero this year in the United States and the euro area – while emerging markets, led by China and India, will perform much better.

This brighter picture has been welcomed by investors, and there has been a powerful market rebound since late September. Investors have repositioned their once extremely cautious portfolios towards historically more normal levels, though with a continued cautious edge. This also means that the favourable valuations we saw last autumn have faded. Today's valuations are more neutral in a historical perspective, especially if we are to get through a recession. By definition, this implies a higher risk of worse market performance than we expect.

In a slightly longer perspective, market performance this past year represented a period of robust normalisation. We once again have clearly positive interest rates in the financial system, while the pandemic bubbles that emerged in 2021 have largely deflated. This creates potential for attractive future return levels. It is also now possible to build different types of portfolios with reasonably high expected returns. This could not be done when key interest rates were zero or even negative, at the same time as parts of the stock market had reached disturbingly high valuations.

In this situation we are thus choosing to maintain a rather neutral risk level in our portfolios, even though we are aware that weak economic growth in 2023 should reasonably lead to a negative corporate earnings trend. We do not expect this to create such strong risk aversion that stock prices will revisit their 2022 lows during 2023. Full-year market performance may be quite good, given the flying start we have seen. This February 2023 issue of *Investment Outlook* describes the details of the current market situation and suggests appropriate risk allocations.

As usual, *Investment Outlook* also includes theme articles. The first is entitled "Global fragmentation – critical inflection point with major consequences". We see worrying signs that the world is moving clearly towards geoeconomic, geofinancial and geotechnological fragmentation. This implies that the world will be divided into several large rival blocs; in practice the countries making up one bloc will only want economic, financial and technological relations with each other. What consequences will this have? The second theme article provides an in-depth look at our inflation forecast. It points towards significantly lower inflation going forward. The mechanics are complex, and the article explains what forces will determine the outcome.

Wishing you enjoyable reading,
Fredrik Öberg, Chief Investment Officer
Asset Management & Investments

Market view, risk exposure and allocation

The inflation peak is behind us, and the need for further central bank tightening is fading. China is reopening and will contribute to an improved economic and earnings environment. Yet we expect a mild recession during 2023, with global corporate earnings growth in the 0 to -10 per cent range. A turning point should occur around mid-2023, and 2024 should be a year of economic recovery without the dramatic fluctuations we have become accustomed to over the past few decades.

The past quarter saw a strong recovery in capital markets, bringing both stock and bond valuations and investor positioning into more neutral territory. Given these conditions, we find it appropriate to have portfolios that are close to neutral in terms of risk. More details about suitable positions can be found below as well as in the sections of *Investment Outlook* about each asset class.

Risk exposure and allocation

Let's start with a brief look back. The war in Ukraine is the event during 2022 that will leave the biggest mark in history books. The main effect of this conflict is huge suffering among the population of Ukraine. But the war is also creating major problems outside that country's borders, putting political and other leaders to the test. From an economic perspective, the war intensified the problem of inflation and initiated an energy crisis that has mainly affected the European continent. Central banks acted late but forcefully via a series of decisions that tightened their monetary policies, which pushed down the generous valuations in the capital market. In addition, the world economy signalled weakness due to sharply elevated prices and interest expenses.

The events of 2022 clearly showed how the capital market and the real economy are intimately connected. Economic data are reported continuously and have an impact on the capital market, which tries to sort out what is most important at each moment and weigh this against such factors as forecasts of future developments, expected corporate sector performance, valuations of financial assets, possible risks emerging on the radar, general risk-taking among other investors, the future actions of central banks and more. During the autumn, some bright spots in global conditions caused stock and fixed income markets to celebrate and rebound from depressed levels. Important events worth following during 2023 include whether inflation continues to fall as expected, whether the approaching economic downturn becomes so deep and difficult that it leads to a structural crisis – or whether it will be shallower and quicker – and how much of an impact this slump will have on corporate earnings and defaults. To figure this out, we will begin by presenting our economic view.

We expect a mild recession during 2023

Late in 2022, both economic growth rates and labour markets turned out to be stronger than feared in both the United States and Europe. So how will 2023 be? Our main thesis is that sharply higher prices and interest rates will lower demand and lead to recession, with Western economic growth ending up at just above zero. However, the energy situation in Europe has improved, which is why we believe that our own continent will not end up in the deep crisis that previously seemed likely. Also reassuring is that inflation has passed its peak and is already falling significantly in the US. This suggests that central banks will soon be done with their key interest rate hikes, increasing the likelihood that the Western world can begin its recovery during the second half of this year. In addition, we expect both China and India to show economic strength during 2023. China is benefiting, among other things, from having dismantled its very tough COVID-19 restrictions and from subsidies and stimulus programmes recently initiated by the government. There are global downside risks, mainly linked to underestimation of interest rate sensitivity, which may deepen the decline in demand. On the other hand, a sharper decline in inflation decline may create room for positive growth surprises.

"Sharply higher prices and interest rates will lower demand and lead to recession, with Western economic growth ending up at just above zero."

In terms of the real growth rate, our forecast means that the 38 mainly affluent OECD countries will manage to achieve 0.7 per cent growth this year and 1.7 per cent in 2024. Looking at the entire global economy, the corresponding figures will be 2.5 and 3.3 per cent, respectively. Towards the end of 2024, we also expect inflation to fall towards the central bank target of around 2 per cent. This should make room for a gradual, if somewhat protracted easing of the substantially more restrictive monetary policies that central banks introduced in 2022. For example, we expect the US Federal Reserve, which has now raised its key interest rate one more time during the first quarter, will now wait until late 2023 before initiating a slow cycle of rate cuts, bringing the federal funds rate down to 3.0 per cent by the end of 2024. The pattern in Europe will be the same, but with a certain time lag. Overall, this forecast can be described as a soft landing – including a recession that is neither protracted nor deep – but the subsequent expected recovery will also be more subdued.

As for the probability of various outcomes and a more detailed explanation, see our "International overview" section, which is an excerpt from the January 24 issue of *Nordic Outlook*. One key factor in making the above main scenario materialise is that inflation will fall in the way we hope. The theme article on page 25 provides a comprehensive analysis of inflation trends.

GDP forecasts, %

Market	2021	2022	2023	2024
World	6.0	3.3	2.5	3.3
United States	5.9	2.0	0.5	1.2
China	8.1	3.0	5.5	4.9
Sweden	5.1	2.9	-1.2	1.1
OECD	5.7	2.9	0.7	1.7
Euro area	5.3	3.4	0.0	1.9
Nordic countries	4.4	2.6	-0.3	1.7
Emerging markets	6.7	3.7	3.9	4.5

The table shows forecasts of 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 January 24.

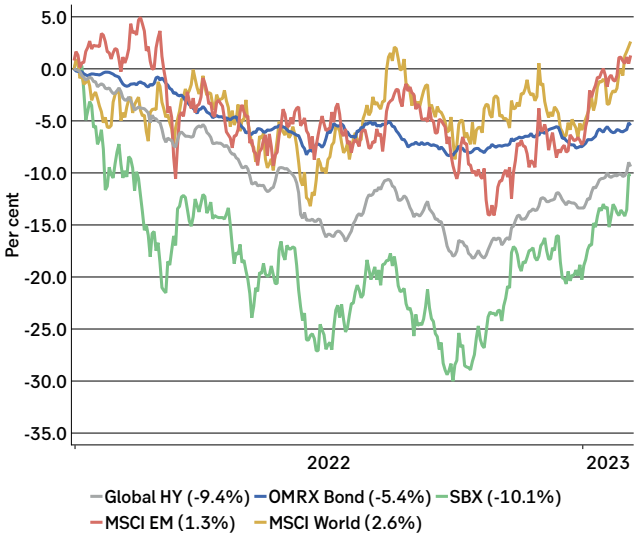
Normalisation has changed the conditions for a portfolio of stocks and bonds

The years between the outbreak of the global financial crisis in 2008 and the impact of pandemic stimulus programmes in 2021 are an interesting and unusual economic period. Central banks and governments provided very powerful support to the world economy via huge capital injections, key interest rates that fell to negative levels, extensive tax cuts and gigantic fiscal stimulus packages. This happened at the same time as strong globalisation forces contributed to growth and held down prices. All of this worked as intended – generating economic growth, stabilising the economic system and having a major positive impact on capital markets. This included very low average market volatility and strong corporate earnings growth. As interest rates reached new record lows, valuations of financial assets climbed. Investors thus felt compelled to increase the risk in their portfolios, since "safe" fixed income investments had zero or negative expected returns. Tangible assets such as real estate and forests followed the same trend. Because the period was so lengthy and inflation was so conspicuously absent, it was hard to imagine a future in which this situation would not remain the norm. Of course, we and other forecasters expected zero interest rates to end and some form of normalisation to occur, but the actual course of events was more dramatic than expected.

When we finally began to see signs that inflation was accelerating, it was reasonable to interpret this initially as the temporary effects of the post-pandemic reopening. Today we know that this was not the case. The past year has been largely dominated by a very rapid normalisation from the 2008-2021 period. Bond yields are now in closer harmony with future expected growth and inflation rates. Pricing and valuations of financial and tangible assets have been adjusted lower as interest rates have kept rising. Risk-taking among investors has moderated, and consumption patterns and loan-to-value ratios have cooled.

There are varying opinions as to whether this process of rising interest rates and falling asset prices is over, or only partially over. But at least a sizeable part of it is behind us, and recent developments point to some reversals in the process. For example, the above-described trend became apparent in the balanced portfolios we handle as part of our discretionary management mandates. A model portfolio including about 60 per cent equities – divided equally between Swedish and global equities – plus 20 per cent fixed income investments and 20 percent alternative investments fell by about 10 per cent during 2022. Alternative investments performed the best, ending up around the zero mark. They were followed by global equities, which at index level lost about 5 per cent measured in Swedish kronor (including a 15 per cent positive currency effect). Then came fixed income portfolios, which ended up with around 7-8 per cent negative returns. In last place at the index level were Swedish equities, which ended up declining by 20 per cent. These are large negative numbers, and there were also unusually large deviations within asset classes. Defensive stock market positions fared best, while growth-oriented shares were among those that had a tough time. It was a painful year, but the spurt in prices during the fourth quarter greatly reduced negative outcomes for the full year 2022.

Portfolios have stabilised, while the krona has rebounded from its low point



Source: Bloomberg

The chart shows the 2022 and early 2023 performance of Swedish equities (SBX), the MSCI World Index and the MSCI Emerging Markets Index in Swedish kronor. Also shown are the performance of the Swedish fixed income index (OMRX Bond) and a global high yield (HY) corporate bond index, currency-hedged to Swedish kronor.

Putting this in perspective, the actual outcome of nearly -10 per cent for investors based in Sweden in the above model portfolio was not so terrible, since the same portfolio returned more than 25 per cent altogether over the previous two years. Last year was not weaker due to the positive currency effect for global equities when the krona weakened. If exchange rates had remained unchanged during 2022, the portfolio would have decreased in value by about 14 per cent. Early 2023 has been strong, showing a positive outcome of about 5 per cent at this writing.

One positive effect of the difficult period we have put behind us is that expected future returns have risen and have probably become more robust, since we once again have a basic interest rate in the financial system that is positive and a situation where many valuation excesses have been sharply reduced, for example via large price declines among shares that had high valuations at the beginning of 2022. As a result, many different balanced portfolio structures – portfolios with several asset classes in different proportions – have healthy expected returns for the next five years. Thanks to higher interest rates, this applies not only to portfolios with high risks and proportions of equities, but to the entire risk spectrum. In a near-term perspective, however, the outlook is cloudier as we now move towards a recession. There is always a risk of falling corporate earnings and other problems that may emerge. Meanwhile stocks and bonds have recovered strongly since bottoming out in late September and early October.

Share valuations are at normal levels and bond yields are reasonable

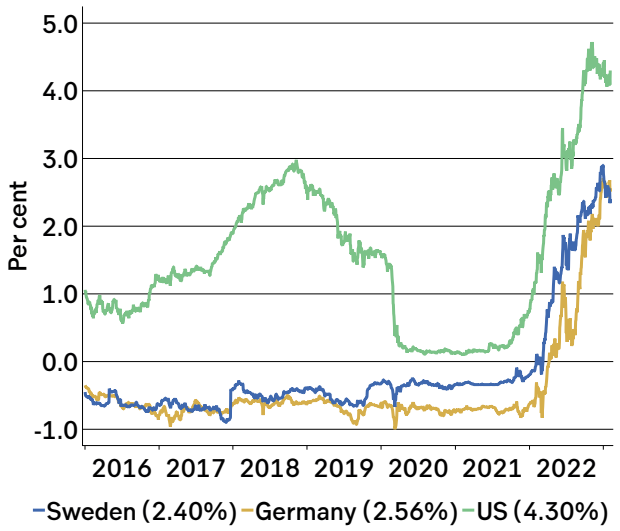
The Nordic and global equities sections and the fixed income section of this *Investment Outlook* describe the near-term potential of each asset class in detail, based on the connection between current valuation and expected earnings as well as the yields on various types of bonds and the probability of losses linked to corporate defaults.

Looking at equities, valuation parameters such as price-earnings (P/E) ratios are in line with the historical average. But there is a clear risk that the earnings estimates that form the basis for current P/E ratios are too optimistic. On a global basis, the consensus forecast of the corporate earnings trend remains positive: in the +5 per cent range during 2023. From a macroeconomic perspective – where a mild recession is our main thesis – it is reasonable for the outcome to be somewhere between zero and minus 10 per cent. This may thus lead to new downward pressure on stock markets this year, but to a lesser extent than in 2022. Valuations are much more reasonable, some of the main problems linked to rising inflation are about to reverse and the economic growth forecast for 2024 is better. Of course, there are also opportunities for positive surprises – for example, a faster decline in inflation and thus lower expected interest rates. In addition, the need for more secure supply chains and a robust transition to more stable and sustainable energy supplies are synonymous with large investment needs, which in themselves offer good business opportunities to parts of the corporate sector.

In the bond market, the situation is stable. The high inflation rate is about to fall, central banks will eventually cut their key rates and a mild recession should lead to only a limited upturn in corporate debt default figures. Plans by central banks to trim their huge balance sheets pose a threat, but these plans will probably be postponed if financial market volatility rises or the cost of divesting bond holdings at a loss becomes too great.

Overall, this indicates that the fixed income market has already priced in the expected normalisation of inflation in a rather reasonable way and that the stock market is also in line with expected earnings growth over the next two years. The valuation gaps between different types of shares have also narrowed and are now closer to historical averages. The same is true in the fixed income market for bonds with different degrees of credit risk, as well as government bonds from different countries and regions. The foregoing does not mean that in 2023, active asset management will be pointless. This year, there will again be wide differences in returns between various assets, and volatility will come and go. Analysis will pay off. So far, the functioning of the market has been more rational, partly because central banks ended large-scale quantitative easing and extremely low interest rates. Vital market correlations and mechanisms are working again – now that the price of money is no longer set at close to zero.

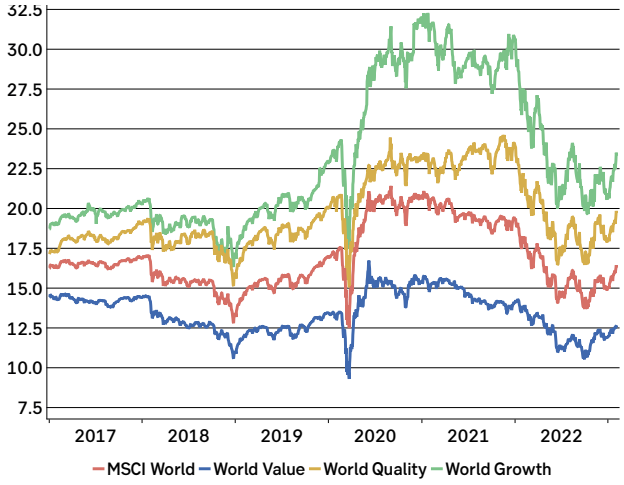
Soaring 2-year government bond yields



Source: Bloomberg

The chart shows the performance of 2-year government bond yields in the US, Sweden and Germany. The upturns are very large and to find such levels, we have to go back to before the 2008 global financial crisis. We expect these yields to decline gradually as an effect of falling inflation and lower key interest rates.

The wide valuation gaps in the stock market have narrowed



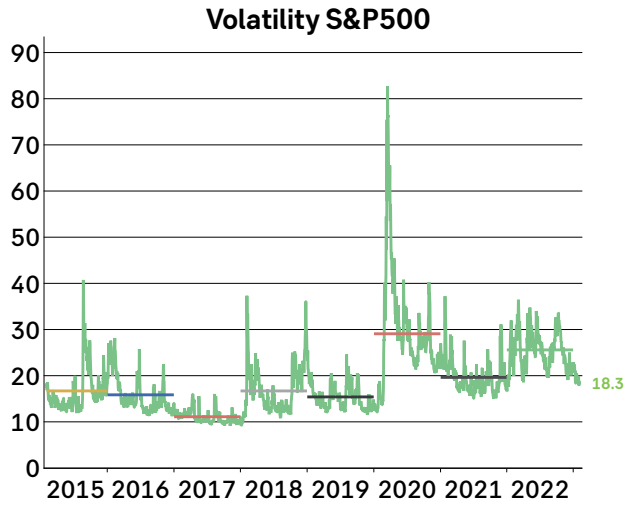
Source: Bloomberg

The chart shows P/E ratios for various types of shares – such as growth companies, quality companies (e.g. high return on equity), a broad global index excluding emerging markets and undervalued companies. We are now back at pre-pandemic levels, and the same applies if we instead study P/E ratio trends by economic sector (IT, pharmaceuticals, etc.).

Investors have boosted the risk level in their portfolios, which have an unusual composition

Surveys of the investor community confirm what market movements are indicating. Risk appetite hit a low in late September, and since then news of slowing inflation, increased economic activity in China and so on has led to a more optimistic view of the future. Investors have done this via a lower proportion of cash equivalents, a clear upturn in the proportion of bonds and progressively longer durations. They have shifted to a marginally higher proportion of equities, but within this asset class they have reduced their holdings of defensive sectors and US-based shares while expanding their holdings in cyclical areas such as Europe and Asia, led by China. Compared to historical averages, their positioning remains defensive – but not nearly to the same extent as it was one quarter ago. When we compare today's risk-taking among investors with historical averages, we must also add the exposures they have built up in alternative investments, such as private equity funds, advanced credit funds, real estate, etc. In that case, today's total exposure appears a bit less defensive and on par with what we would expect when the level of economic activity is projected to fall. Once we have made it through the recession, risk-taking will be higher, but if we underestimate the downturn there will be room for investors to reduce their risk along the way.

We have left ultra-low stock market volatility behind us



Source: Bloomberg

The chart shows volatility in the US stock market, as measured via the options market (VIX Index). The average volatility in recent years is well above that of years dominated by quantitative easing (QE), i.e., stimulative asset purchases by central banks. It is reasonable to conclude that this is an indication of the future, because we do not expect central banks to use QE over the next couple of years.

Risks that currently need to be monitored

In general, the risk picture improved during the autumn, but the weaker economy and a more dramatic decline in corporate earnings than expected would automatically put pressure on the valuation parameter and create investment flows back towards more defensive positions.

Another potential risk might be a slower inflation decline than we are expecting. This would result in higher key interest rates and bond yields for an even longer period than if inflation falls as projected, which in turn would have a negative impact on consumption and run the risk of eroding current financial asset valuations as well as triggering more defaults and funding problems in the corporate sector.

Future developments in the Ukraine war are hard to predict, but there are obviously risk scenarios that might lead to major consequences. Investors are hoping the war will end within the foreseeable future, but it is more likely that there will be a low-intensity war in which the West provides more support and makes it difficult for Russia to advance further.

Good rotation and temporary weakness suggest a need for broad exposure and patience

We avoided many pitfalls during 2022 by making a downward adjustment of the risk in our portfolios late in 2021. This was done by lowering the proportion of equities and corporate bonds, choosing short interest rate durations and maintaining low connections with both equity and fixed income markets in the portfolios containing alternative investments. With the benefit of hindsight, we should have gone even further; during the first half of 2022, ultra-defensive strategies were the best performers. However, full-year outcomes showed that broad portfolios with good risk diversification were able to withstand the torrent of bad news that affected capital markets. During the autumn, we adjusted our composition by gradually adding exposures in our Swedish equity portfolios to companies other than the year's winners, value companies – shares with low valuations compared to the stock market average, such as industrials and banks. Now that elevated interest rates have squeezed stocks in the growth segment and some so-called quality companies, we may again find shares in these categories that are attractively priced.

In our global equity portfolio, we are currently overweighted towards large cap growth companies, smaller companies with low valuations and emerging markets, led by China. In addition, we are using a partial currency hedging of the US dollar, since we expect the Swedish krona to appreciate further. In our fixed income portfolios, we now have a slight overweight in corporate bonds and much longer durations than before, though still somewhat shorter than our benchmark indices. In portfolios that include alternative investments, our strategy continues to maintain a low connection to other sub-portfolios, equities and bonds in order to achieve risk diversification.

At the overall portfolio level, this means that we are letting Swedish and global equities lead the way, depending on interest rates and risk appetite. They simply complement each other. The fixed income portfolio is positioned for a slow decline in interest rates and for avoiding being affected by a surge in corporate credit events. Our allocation between asset classes is rather neutral, with some overweight for equities after the recent stock market rally. Being close to neutral means that we expect to benefit from risk premiums and that our portfolios will generate positive returns in the coming period. This is synonymous with corporate bonds providing higher returns than government bonds and stocks providing higher returns than corporate bonds over a somewhat longer time horizon. We are not further increasing our proportion of equities, because of the impending economic downturn combined with neutral valuation signals and the fact that bonds have an attractive expected return, since we believe that high bond yields will fall. This will also serve as a stabiliser against possible corporate earnings and cyclical disappointments.

Global equities

Every cloud has a silver lining

Falling inflation and macroeconomic data that indicate mildly decelerating growth rates, but not necessarily a recession, have instilled courage in the battered investor community. This year has begun with rising stock markets – the leaders have been European and Chinese exchanges fuelled by falling natural gas prices and the reopening of China. Over the next few quarters, consensus earnings expectations will be challenged by cost increases and slowing volume growth, but if we look ahead to the second half of 2023, the outlook is brighter.

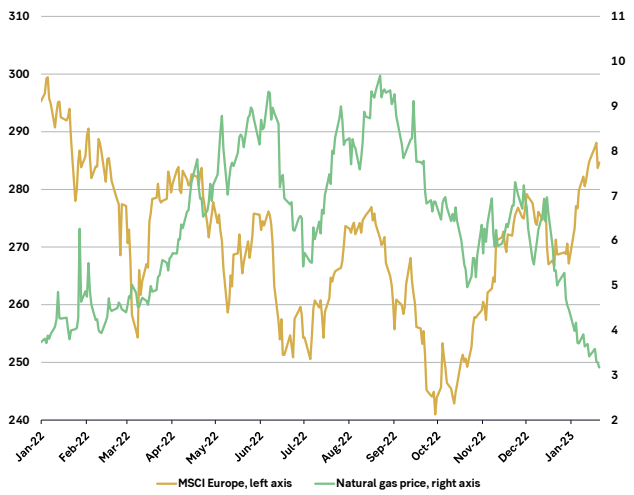
It is reasonable to believe that the stock market bottomed out in mid-October last year – when a European energy crisis was imminent, at the same time as China was redoubling its lockdowns to curb the spread of COVID-19. Fortunately, we have seen a mostly mild winter in Europe, causing steeply falling natural gas prices. European stock markets have responded to the improved conditions. At present, it appears possible for Europe to avoid a recession and instead experience a mild economic slowdown.

The perception that things have bottomed out has been reinforced by several bright spots that have emerged over the past few months, especially in the inflation picture. They offer hope for an early end to central bank interest rate hikes and have caused long-term bond yields to fall.

China's post-reopening recovery

China dismantled its zero-COVID policy earlier than expected, leading to upward adjustments in GDP growth forecasts. Chinese stock exchanges, which fell sharply during the lockdowns, have recovered their losses – gaining 50 per cent since their lows in late October.

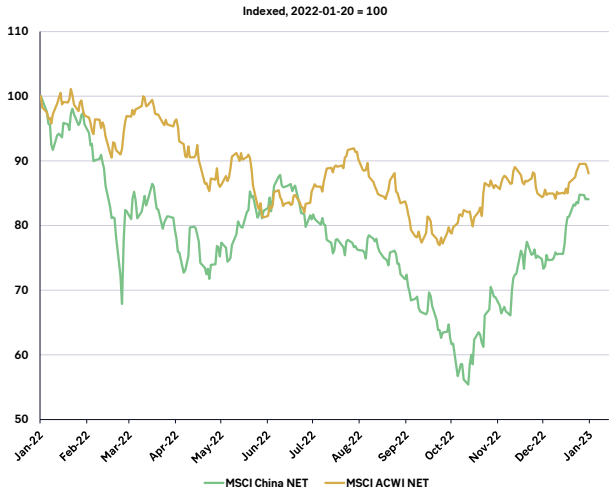
Negative correlation between natural gas prices and European stock indices, late 2022 and early 2023



Source: Bloomberg

The chart shows price indices for natural gas and equities in the MSCI Europe index. For a long time, fears of an energy crisis lay like a wet blanket over European stock markets, but as natural gas prices declined, risk premiums tumbled and economic growth forecasts began to climb.

Steep rebound for Chinese stocks since their low point



Source: Bloomberg

The chart shows the performance of the MSCI China equity index compared to the MSCI World Index. Since bottoming out, the MSCI China has gained about 50 per cent. This index is dominated by China's information technology (IT) giants. A broad index of domestic Chinese companies (so-called A shares) has not shown the same volatile performance.

Valuations on Chinese stock exchanges are now at historical averages, with a price-earnings (P/E) ratio of 11.5 for the MSCI China index and 12.2 for the CSI 300 (consisting of A shares that mirror the domestic stock exchanges in Shanghai and Shenzhen). The overall trend for Chinese equities seems attractive compared to equities in other regions, since earnings estimates should move upward rather than downward thanks to monetary and fiscal stimulus and a faster reopening than expected. In addition, such Chinese-related risks as the country's erratic political leaders and their power struggle with the United States, as well as the housing crisis, have recently subsided.

China is aiming at self-sufficiency in technologically advanced fields such as semiconductor manufacturing, environmental engineering and electric vehicles, and this is powering economic development. China is thus an attractive country for investors in the long term. For example, the country has already come a long way in its green technological transformation. China is a leader in solar energy production, as well as electric vehicles. Within a decade, the Chinese hope to achieve world domination in semiconductor production as well. For Western investors, however, it remains a difficult balancing act to reconcile China's political governance and lack of corporate accounting transparency with long-term attractive opportunities.

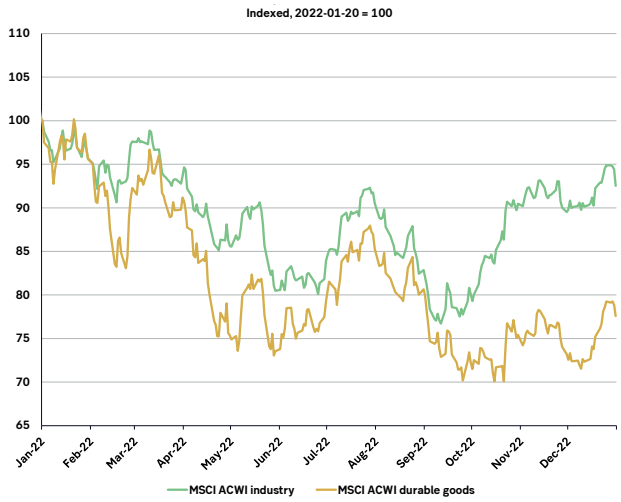
Today's earnings forecasts probably need to be adjusted lower

Analysts expect corporate earnings to increase by 5 per cent globally this year, which is rather optimistic assuming that economic growth in the US and Europe will end up around zero. Although inflation is helping nominal earnings growth, with companies saying there is an acceptance of price increases – compensating for general cost increases – we must expect depressed profit margins and aggregate earnings reduction in real terms. But we are in good company; surveys show that portfolio managers expect slightly negative earnings growth this year.

The market is thus likely to withstand some downward adjustments. If growth turns out weaker than expected, however, there are downside risks both for earnings and share prices.

Equity investments have performed relatively well during the current economic slowdown – especially among industrial, materials and commodity companies – while the interest-sensitive consumer sector and traditionally indebted sectors such as real estate have fared significantly worse.

The cyclical manufacturing sector is coping much better than the cyclical consumer sector

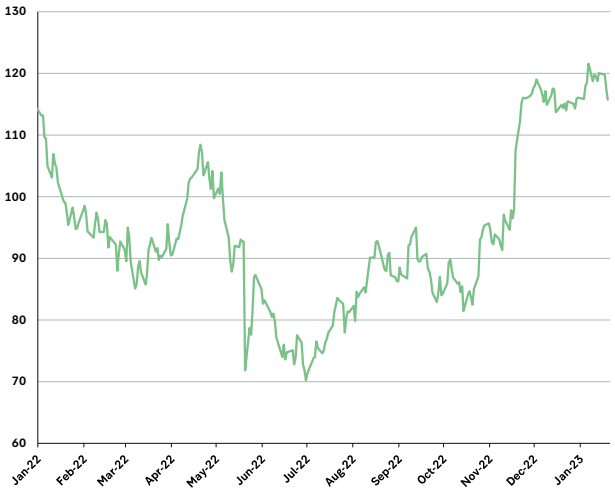


Source: Bloomberg

The chart shows the performance of the global industrial and cyclical consumer sectors, according to the MSCI All Country World Index.

It is also clear that consumers are looking for cheaper price alternatives, a classic pattern exemplified by Ross Stores, an operator of discount and outlet stores in the US, which has noted an increasing influx of customers.

The American consumer is gravitating towards low-cost alternatives

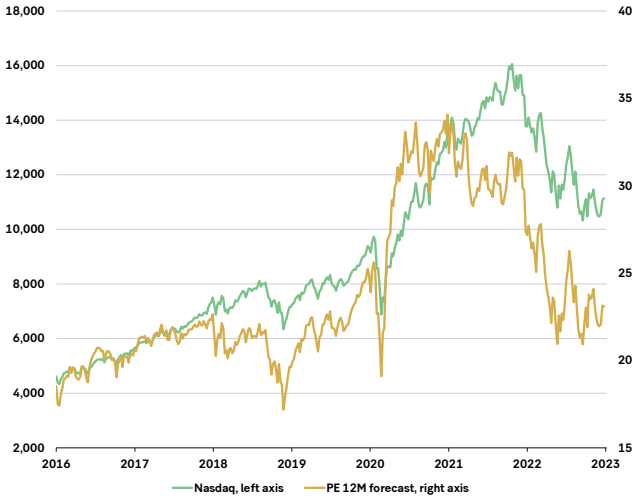


Source: Bloomberg

The chart shows the share price performance of Ross Stores, a company that operates discount and outlet stores in the US. The company has noted an increasing influx of customers.

Last summer, earnings estimates for the stable IT giant Apple began to fall, though modestly. Earlier, earnings estimates for other well-known tech companies such as Meta (parent of Facebook), Amazon and Netflix also fell drastically. Nor did Alphabet (parent of Google), which is sensitive to advertising sales, avoid downgrades in earnings estimates. In classic American fashion, these companies have quickly taken steps to protect their profitability, mainly by laying off employees. Apple is the only one of the above-mentioned companies that has not announced extensive downsizing, yet. News of downsizing has been favourably received so far by the stock market, indicating that the investor community has adjusted its expectations compared to previous overly positive growth forecasts.

Nasdaq – valuations have normalised



Source: Bloomberg

The chart shows the performance of the Nasdaq Composite index and the average P/E ratio (based on 12-month forward earnings forecasts) over the same six-year period.

Cautiously optimistic

Investors remain cautious in their risk-taking, which is providing some support, but after the recent stock market upturn it is difficult to argue that valuations are especially attractive. Globally, the average P/E ratio is just over 15, where the US with its growth company focus still pulling up the figure. This is well below the highs during the post-pandemic recovery, but also somewhat above the lows of previous recessions.

However, ratios of share price to book value (the price-to-book or P/B ratio) are higher than normal, indicating that investors expect above-normal profitability. If the economy should fall more than expected, profitability is likely to deteriorate and valuations will be challenged.

Short-term downward adjustments in earnings forecasts and rising share prices justify a cautious approach to stock markets in the near future. However, assuming that our main growth scenario proves correct, we are approaching the point where it will be time to look ahead towards the next phase. Earnings growth should rebound during the second half of 2023, which will probably coincide with the end of central bank tightening. The long-term stock market outlook appears hopeful.

Valuations of future earnings have normalised

Source: Bloomberg

The chart shows the changes in the average P/E ratio over the past five years.

P/B ratios are making demands on profitability

Source: Bloomberg

The graph shows average price/book ratios (share prices divided by book value per share) over the past five years.

Nordic equities

Cautious optimism

The Stockholm stock exchange has surged 24 per cent since it bottomed out in September, driven mostly by the factors that we identified as positive drivers in November but which could also be glimpsed to some extent as early as September. The inflation problem has not gone away but is fading fast in the US, which is first in this cycle among the major economies. Meanwhile, the European energy crisis does not look set to be nearly as bad as could have been feared. A normalisation of investor risk appetite from historical extremes in late autumn has also normalised valuations on the Nordic exchanges; the time for stock market bargains is already over.

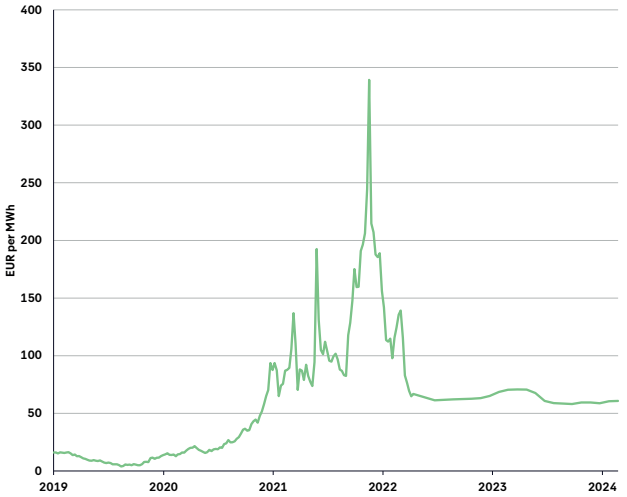
In addition, political developments in China have abruptly shifted in a positive direction for the economy and financial markets. The corporate earnings trend has also been encouragingly solid and far different from the doomsday scenario continuously depicted in the media over the past year. Unfortunately, three of the five factors providing strong support for the stock market have already more or less faded, which suggests a limited but positive share price trend for the rest of the year. We still expect the recovery in 2022-23 to be completely different from the euphoria of 2021 and thus fear new setbacks for many of the equities that saw the biggest declines in 2022 and have shown the strongest performances so far this year on the Stockholm stock exchange. The drivers of the current recovery are totally different from those in 2020-21.

The energy crisis is not over, but the worst phase is past

The energy crisis dominated the past year in important respects, but the stage is set for a sharp fall in energy costs as early as 2023. This will limit the negative impact of these costs on both industrial activity and consumer purchasing power. Current forward prices indicate a halving of natural gas prices in 2023 compared to 2022. That is still three times higher than normal before Russia invaded Ukraine, which should drive continued investments in energy efficiency and more reliable energy sources, but the crisis situation is much less severe than was previously feared.

The most important explanation for the surprisingly mild impact of Russia's energy policy warfare on Europe is probably the remarkably rapid adaptive capacity of industries and households. A combination of reduced energy use and a sharp increase in purchases of liquefied natural gas (LNG) from other regions – along with other adaptations – has tempered the effects of the loss of Russian gas in a way that few, if any, would have dared to predict one year ago. Moreover, mild winter weather has further helped to reduce the need for natural gas. With unusually large gas stocks today, the winter of 2023-24 will also be easier to manage, no matter the weather. The longer the time horizon, the better the prospects that companies and households will switch to more reliable and sustainable alternatives. Some solutions now accounting for this surprisingly good ability to manage the energy crisis – for example, extended service life or reopening of coal-fired power plants and mines – are short-term and unsustainable, but they help provide some respite. Used properly, this respite can be employed for investments in energy efficiency and the expansion of new reliable and sustainable energy sources.

Energy costs halved in 2023



Source: Bloomberg

The chart shows natural gas forward prices in the Netherlands for next-month delivery in euro/MWh for the period October 2019 to January 2023, and then forward prices as of January 2023 for the remainder of 2023 and 2024. Prices are still high from a historical perspective – about three times higher than normal before the war in Ukraine – but the average price in 2023 suggests a halving compared to 2022.

> *"For most big Nordic listed companies, energy price declines over the past few months have improved their outlook for 2023 significantly."*

China is easing up and taking off

China was a major problem and source of concern for companies and investors during much of 2022. The country's COVID-19 strategy was an economic and humanitarian disaster but has now come to an abrupt end, which bodes well for 2023. Persistent and harsh lockdowns undermined domestic consumer confidence, worsened the real estate crisis and greatly exacerbated global problems with unreliable supply chains. These problems are now improving quickly, which for many big Nordic companies means better demand in one of their most important markets. Meanwhile, production and delivery disruptions, in many cases directly linked to operational shutdowns in China, are already easing significantly.

Virtually every manufacturer is to some extent dependent on Chinese suppliers. Every major industrial company, the entire commodities sector, the biggest pharmaceutical groups and some of the large Nordic consumer goods companies all have China as one of their biggest markets (in many cases right behind the EU and the US/North America).

Stable earnings forecasts

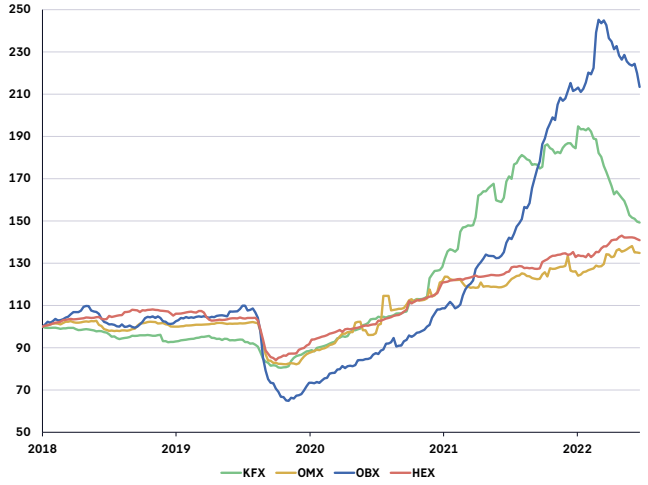
Not everything is crisis and hardship – there are sectors that benefit from the current environment of high interest rates and large-scale investments in energy and energy efficiency. Obviously, the situation is problematic for the consumer goods sector and will further deteriorate due to apparently extensive inventory reductions throughout the value chain. Inventory adjustments will probably be especially crucial in determining when durable goods sales bottom out. At the same time, the importance of consumer goods and the retail sector to the Nordic stock market should not be exaggerated. The two sectors have seen weak earnings growth since 2022, when earnings fell 34 per cent to a total of 5.3 billion euros, which is also 12 per cent lower than five years ago. In comparison, industrials are expected to increase earnings by 8 per cent to a record 21 billion euros, while banks (including SEB, for which we instead use the consensus forecast) are expected to generate earnings of 19 billion euros. The Nordic economic sector with the best earnings in 2022 was oil companies – we expect full-year earnings of 26 billion euros. The health care sector probably enjoyed 20 billion in earnings during 2022, and further growth of 18 per cent is forecast for this year.

At SEB's Nordic Seminar for investors in Copenhagen during January, which was held in person after a two-year pause, CEOs or CFOs of 135 Nordic listed companies gave open presentations about their outlook. The picture is somewhat mixed but hardly one of imminent, deep recession. The same is true of the start of the Q4 2022 earnings report period. Although it had barely begun at this writing, any drama has been conspicuously absent. The problems noted in quarterly reports are primarily company-specific or in the consumer goods sector. This is the fifth straight report period in which analysts expected companies to warn about a much worse outlook going forward, but so far this scenario has not come to pass. However, the recent sharp fall in energy and transport prices changes the relationships between different sectors and regions. In the Nordic countries, we clearly see how earnings forecasts have recently slumped in Norway and Denmark, precisely because of lower energy prices and container freight rates, while many companies in Sweden and Finland benefit from those factors.

Falling inflation provides support

Inflation continues to fall rapidly in the US, fully in line with the historically normal patterns we noted in November. Leading indicators still point to a continued steep fall this year. While opinions vary as to how quickly and sharply inflation will fall and what actions central banks, led by the US Federal Reserve, will and should take, there is already investor consensus that inflation is now falling. Long-term (10-year) US inflation expectations are back down to just above 2 per cent since October, after peaking at around 3 per cent in April 2022. It is generally expected that a number of factors will push overall inflation down sharply. There are still concerns about core inflation, and specific cost components such as wages and rents have drawn considerable attention. A softer labour market would bolster equities for the remainder of the year, while the stock market has probably already factored in a decline in overall consumer price inflation after the recovery of recent months.

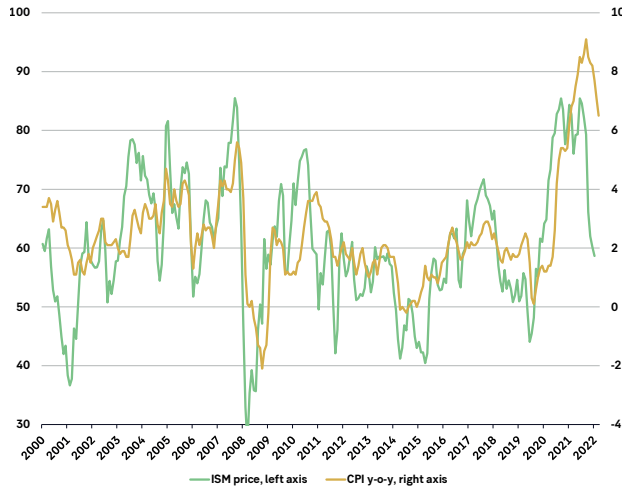
Earnings trends for Swedish, Finnish, Danish and Norwegian large caps out of step



Source: Bloomberg, SEB

The chart shows indexed rolling 12-month forward earnings forecasts for companies in large cap indices for Sweden (OMX/OMXS30), Norway (OBX), Denmark (KFX/OMXC20) and Finland (HEX25/OMXH25). Weak European currencies made a significant positive contribution last year, but the effect of this is now quickly fading. Earlier, Norwegian and Danish companies were favourably affected by higher energy and transport costs, but recently these costs have had the opposite effect. For Swedish and Finnish large caps, the earnings trend will remain stable and probably be more positive than many people expected just six months ago.

Purchasing managers are talking about a rapid slowdown in US inflation



Source: Bloomberg, SEB

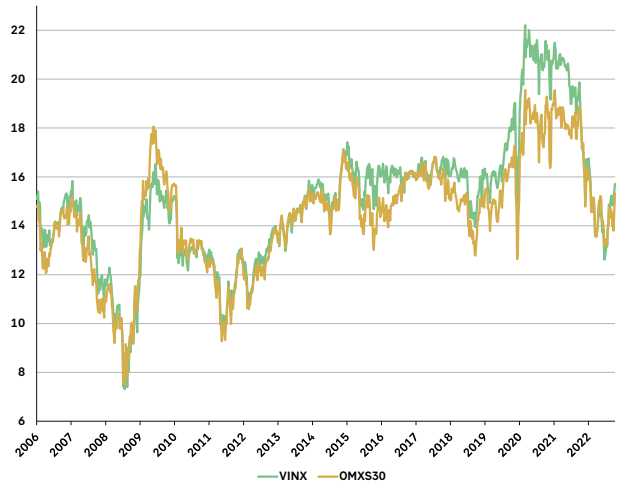
The chart shows US inflation – using the consumer price index (CPI) – and the average of price components in the Institute for Supply Management (ISM)'s Purchasing Managers Index (PMI) for manufacturing and services in the US (ISM and Non-Manufacturing ISM). The ISM index has historically been a good inflation indicator and is now falling rapidly, mostly for manufacturing, but the index for the service sector has also fallen substantially from its earlier peaks.

Neutral valuations suggest limited upturn potential for the rest of the year

After the stock market surge of the past four months, valuations in the Nordic region and Sweden are once again at historically normal levels. The same phenomenon is reflected in statistics for institutional investor positioning, with holdings of cash equivalents back at nearly normal levels after reaching their highest levels for more than 20 years in September/October. Historically, extremely high cash holdings have rarely been a reliable signal that the market is nearing its bottom. With virtually neutral valuations and almost neutral positioning even now, the upside for the rest of 2023 should be relatively limited despite some overweight for other factors favourable to the stock market. The conditions that led to the abnormally high valuations seen in 2021 were created by the extremely loose monetary policies pursued during the pandemic, and a return to that today seems highly unlikely.

It is not just stock market valuations as a whole that should be affected by more normal monetary policies during the ongoing recovery than in 2020-21. Sectors and individual equities should probably also remain closer to historically normal patterns and valuations. The bubbles that were pumped up in 2021 but then deflated again in 2022 are now apparently attracting speculators hoping for a repeat of the previous recovery. We believe the fundamental conditions needed for a repeat performance are lacking and recommend investments based on conventional valuation principles.

P/E ratios in the Nordic region and Sweden



Source: Bloomberg

The chart shows P/E ratios (12-month forward consensus) for the VINX Nordic Index and the OMXS30 index of the 30 most liquid equities on the Stockholm stock exchange. After a strong upturn in recent months, valuations are now back at historically normal levels.

Summary and conclusion

The combination of rapidly falling US inflation, a much less severe energy crisis than might have been feared, the reopening of China, continued relatively stable earnings growth and a recovery in investor sentiment from exceptionally negative levels in late autumn has fuelled the stock market surge of recent months. We foresee continued support from falling energy prices and China's reopening going forward, but share valuations have already normalised, which should mean a much slower stock market upturn during the rest of this year. Because of lower inflation, there will be no new central bank stimulus programmes like during the pandemic; instead, a return to a historically more normal situation is most likely. This will have a big impact on share valuations and is a strong argument for ruling out a return to the extreme valuation differences between different equity categories seen in 2021. We believe this bodes well for sectors such as industrials, cyclical consumer goods companies and equities with low valuations combined with profitable growth.

Industrials are attractive, given their combination of appealing valuations and steady earnings growth. Cyclical consumer companies have a more uncertain outlook and are showing depressed earnings but historically low valuations; investors will probably start factoring in the next upturn as soon as the sector has finished adjusting inventories.

Fixed income investments

A satisfactory source of returns again

During much of 2020, 85 per cent of the world's outstanding government bonds generated a yield of less than 1 per cent, with a sizeable share of them generating 0 per cent or less. Central bank rescue actions in the form of almost unprecedented interest rate cuts at the start of the pandemic led to a situation where government bonds generated no returns and lost their historical effect of diversifying risk, mainly against equities. In early 2022, when inflation caught the world's central bank governors off guard, the result was historically large rate hikes – moves that caused risk assets and government bonds to fall in value. Now, early in 2023, the situation is different. Interest rates and yields have reached levels not seen in many years, and fixed income investments are once again a satisfactory source of returns. And the closer we get to some form of normal situation for inflation and interest rates, we should also see the diversifying effect of bonds again.

Government bonds (excl emerging markets)
With most central banks expected to end their rate hikes this spring, government bond yields started the year off in a downward direction. This is a recognisable pattern historically – bond yields tend to fall from their peaks somewhat before central banks end their hiking cycle.

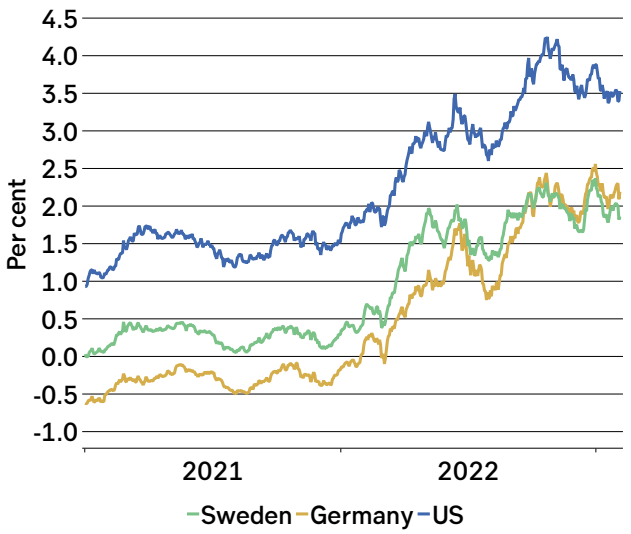
Looking at the US, we expect the key interest rate to peak at 4.50-4.75 per cent during the first quarter of this year, followed by the first rate cut in December. Market expectations for the Federal Reserve's peak interest rate have been relatively stable at around 5 per cent since October.

Growing expectations about future rate hikes have recently pushed 10-year Treasury yields down nearly 1 percentage point from their October 2022 peak of 4.30 per cent to around 3.35 per cent at present. We expect yields to move in the 3.25-3.75 per cent range during most of 2023, before nearing 3 per cent towards year-end. The outlook for 2024 is more uncertain and depends on what the Fed does, but the market's current pricing of 10-year Treasury yields is around 2.75 per cent – in line with our assumptions.

In Europe, the picture looks somewhat different. The European Central Bank is far more concerned about inflation and has clearly indicated further key interest rate hikes. We believe the ECB's key rate will reach 3.25 per cent by May, but unlike the Fed the ECB will wait until mid-2024 to lower its key rate. Meanwhile, the ECB will also reduce its bond holdings during 2023, which is expected to have a tightening effect. All in all, we foresee slightly higher European bond yields over the next few months, with countries in southern Europe possibly seeing somewhat bigger upturns. The market still has a cautious view of ECB rate cuts, but we believe expectations will fall during the year, which will probably limit the upturn in bond yields even before the first key rate cut is implemented.

The yield spread between Swedish and German bonds widened at the start of 2023, driven by expectations of further ECB rate hikes and earlier rate cuts by Sweden's Riksbank. Meanwhile, Swedish bond yields are being pushed down due to weak bond supply. As a result, 10-year Swedish government bond yields are currently trading at 25 basis points (bps) below corresponding German yields. Nonetheless, we expect the Riksbank to start selling some of its bond holdings during the second half, which will probably help Swedish bond yields to overtake their German counterparts later this year. We believe that the yield spread between Swedish and German 10-year government bonds will be 20 bps at the end of 2023, since our forecast for 10-year Swedish government bond yields is 2.20 per cent.

Trend of sharply higher long-term bond yields has reversed



Source: Macrobond

Long-term bond yields rose sharply during much of 2022 in view of rising inflation and central bank rate hikes. However, during the final quarter of the year, this trend reversed and yields have now come down from their peaks.

10-year government bond yields (forecasts)

	Feb 19	Jun 2023	Dec 2023	Dec 2024
United States	3.52	3.40	3.00	2.80
Germany	2.20	2.30	2.00	1.90
Sweden	1.92	2.30	2.20	2.10

Source: SEB, forecasts February 2023

Since we believe most leading central banks will implement their final rate hike during the first half of 2023, our forecast is that 10-year government bond yields will fall during the second half of the year.

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

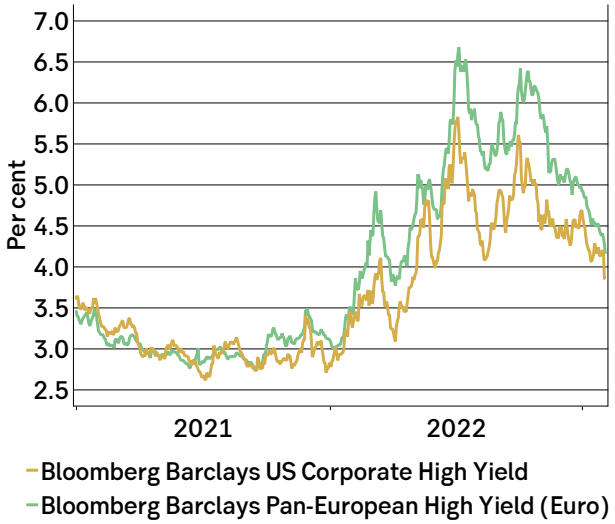
Since the return on corporate bonds is generated by the interest risk and credit risk the bond carries, it is somewhat easier to work out the picture of the challenges that emerged in 2022. Due to sharply higher bond yields following aggressive central bank key interest rate hikes, together with wider credit spreads because of higher credit risk – given generally worse economic conditions – both sources of return had a negative effect on corporate bonds in 2022. However, the situation looked brighter late last year and early this year. Fears of continued rate hikes and recession in October have now been replaced by hopes of central banks nearing their final rate hike, a soft economic landing and future rate cuts.

Although companies faced economic challenges in 2022, they handled the situation rather well. During the third quarter, as companies continued to deal with weaker economic growth and persistent inflation, they delivered quarterly reports that collectively lived up to expectations. Default rates among companies with high credit risk that issued so-called high yield (HY) bonds also remained relatively low during the year, though we saw a rising trend. According to the credit ratings agency Moody's, default rates for this type of company moved from about 2 per cent in January 2022 to just below 3 per cent at year-end. The historical average (1983-2021) is about 4 per cent. Given continued challenging conditions, with weaker economic growth and high interest rates during some of 2023, default rates are expected to climb to about 5 per at the end of this year.

The upturn in interest rates and yields last year was a major factor contributing to the fall in corporate bond prices, though every cloud has a silver lining. The same upturn in interest rates means that the underlying base interest rate for corporate bonds, together with the credit risk premium (credit spread), has now reached attractive levels in absolute terms. Today US high yield bonds generate a current return of about 7.5 per cent, while the corresponding return for European HY bonds is about 7 per cent. For the investment grade (IG) segment, where companies have a lower credit risk but instead a longer duration and higher interest rate risk, the current return is just below 5 per cent for US IG and about 4 per cent for European IG.

Corporate bonds in both the HY and IG segments performed strongly during the first three weeks of 2023. Falling bond yields have led to higher prices on account of the interest rate component, while the credit spread (credit risk) in both the US and Europe has narrowed since the market believes recession risks have decreased. Looking ahead, this means less support for bond prices in the short term from further rate downturns given the downturns we have already seen recently. It is not unlikely that we will see bonds trend flat at around current levels in the months ahead. As for credit risk, the near-term trend is connected to Q4 2022 corporate earnings reports, which will provide confirmation whether companies have again managed to cope with higher costs and an economic slowdown. Relatively low credit risk (narrow credit spreads) today indicates that the market has factored in a decent outcome for the earnings season, which suggests there is a risk of disappointments and higher credit risk if reports do not live up to expectations.

Hopes of a reduced recession risk have boosted company outlooks



Source: Bloomberg, Macrobond

With ever-growing confidence that central bank rate hike cycles are nearing an end, there is a reduced risk of recession. This has caused credit spreads to narrow, given hopes of a better economic climate for companies.

Emerging market debt (EMD)

Like other risk assets, EMD performed positively during the final quarter of 2022 – a trend that has potential to continue for a while. With inflation trending downward, and prospects of a milder economic slump than feared earlier, this trend enjoys firm support. How the US Federal Reserve chooses to act in 2023 will be a decisive factor here, since it will affect both US dollar-denominated yields and the USD.

Another decisive factor in emerging market performance is whether China can continue the positive trend noted at the end of 2022. The reopening of the country's economy after earlier stringent COVID restrictions continues. Meanwhile, reduced pressure on the Chinese real estate sector and easing of previous regulatory measures in other economic sectors will also be contributing factors. This should ultimately lead to increased demand for commodities, services, tourism and technology. It will not only benefit China but should also be positive for trade and exports in other countries.

Excluding China, many emerging markets will probably see lower economic growth during 2023 than in 2022. But many of these countries will also see lower inflation, smaller deficits and less debt. There is potential for optimism, but the trend in the US and China will largely affect the outcome.

Theme: Global fragmentation

A critical inflection point with major consequences

Warning bells are ringing as the world faces a critical inflection point. Economists and various international organisations, such as the International Monetary Fund (IMF) and the World Bank, now see a disturbing pattern in which the world is taking clear steps towards geoeconomic, geofinancial and geotechnological fragmentation. This means the world is being divided into a number of large rival blocs, with countries in each bloc – in practice – only wanting economic, financial and technological relations with each other.

Countries today are using economic policy to a growing extent to build up their "national defence" – partly through increased self-sufficiency (so-called strategic autonomy) and partly through reduced dependence on rivals – as well as to prevent the rise of new economic and military superpowers.

The question being asked in corporate boardrooms and economic policy circles is: how great is the risk of permanent fragmentation, in other words, of the world being divided up into different economic, financial and technological trade blocs? There is enormous and growing interest in this question, which was confirmed when it was made the theme of this year's World Economic Forum meeting in Davos, Switzerland, held January 16-20 – Cooperation in a Fragmented World – and because the number of times this issue has been mentioned in corporate earnings reports has increased tenfold in just two years, according to the International Monetary Fund (IMF).

The role of systemic crises in fragmentation

The world is now in an extremely complicated and uncertain situation, which is affected by a number of severe crises. The COVID-19 pandemic, the war in Ukraine and climate change are three partly intertwined systemic crises that have become catalysts for major changes in the world and have initiated processes among various decision makers within a historically short period of time – processes aimed at assessing and rethinking economic, financial and security policy relations as well as desired and undesired dependency relationships.

These systemic crises are accompanied by other ongoing structural trends, which include clear demographic headwinds such as ageing populations, pandemic-related imbalances and rapid advances in the Fourth Industrial Revolution. Meanwhile, the climate and energy crises and the war in Ukraine have increased the need for an accelerating energy transition.

Some of the fragmentation now under way has an economic and financial logic and should therefore be embraced. These systemic crises have exposed unwanted weaknesses and vulnerabilities in companies' global value chains, which need to be addressed. However, tensions around global trade, technology and security have increased in recent years, with a spotlight placed on trade and technology disputes between the United States, the European Union and China, among other matters. So there are reasons to build a more secure, more stable and greener economic and financial system – but in a way that meanwhile does not jeopardise the gains achieved from an integrated, globalised world.

Tectonic shifts in the global playing field affect the global economy

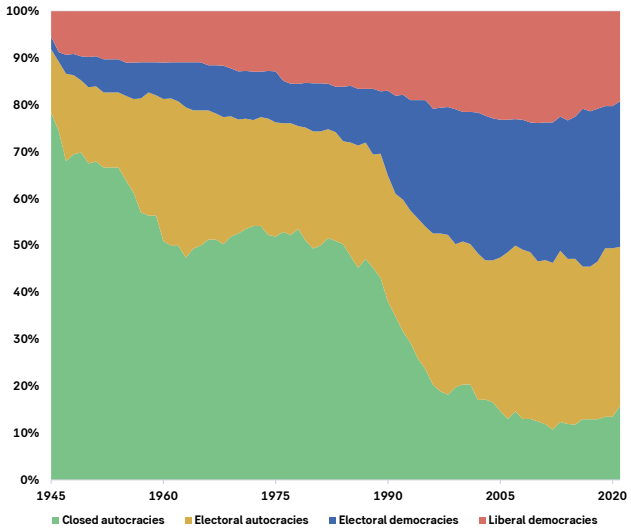
Geopolitical changes interact with economic challenges and technological shifts in a very powerful way. Increased fragmentation entails numerous long-term risks and potential costs – lower profitability and poorer resource use, deferred and generally lower investments, decreased innovative capacity and dissemination of knowledge, reduced productivity and lower employment. It is unfortunately difficult for economic models to quantify the effects of this at present.

The IMF's cost calculations for geoeconomic fragmentation vary significantly, depending on different assumptions about future developments. The IMF warns that the cost may be as much as 7 per cent of global GDP, equivalent to 7 trillion US dollars. However, some calculations indicate that the cost of fragmentation would be much higher.

Geoeconomic fragmentation also reinforces oligopolistic domestic structures as global competition and technology transfers are restricted and regionalisation gains ground. This fragmentation can inhibit production, investments and innovation, which are needed, for example, to replace carbon-intensive processes with climate-friendly ones. The goal of a carbon-neutral planet will be harder to achieve without rapid, globally available technological solutions. These, in turn, depend on the exchange of knowledge, raw materials and people needed for the speedy electrification of our economies.

All in all, this may lead – in a longer perspective – to higher costs for companies and higher inflation and thus higher interest rates, including for households. In the short term, global inflation is expected to fall as pandemic-related supply and demand imbalances narrow and supply disruptions ease. But the structural effects of fragmentation on inflation and interest rates may cause persistently higher global inflation and higher interest rates due to a higher inflation risk premium, as well as higher demand for capital in a financial market that also risks becoming fragmented.

The future of democracy



Source: ourworldindata.org/democracy

Companies must take into account increased geopolitical and domestic political risks in their business models. There are signs of an increase in the number of autocracies (authoritarian regimes without general elections), and the new security policy situation may reinforce this trend.

Geofinancial fragmentation

The rapid, powerful economic globalisation of recent decades has also led to a parallel globalisation and integration of national financial and credit markets. Increased global trade in goods, growing interest in direct investments and ever larger global savings imbalances have bolstered the need for cross-border capital flows, risk reduction opportunities and supranational institutions that work to ensure a smoothly functioning international monetary system, controlled in part by such organisations as the IMF and the Bank for International Settlements (BIS) in Basel. However, there has been growing criticism from emerging markets that they are underrepresented in the international monetary system.

The financial isolation of Russia by other countries, including a freeze on the Russian central bank's currency reserves, has created legitimate concerns – for example among central banks in emerging markets and commodity-producing countries as well as these countries' state-controlled pension funds. The world's biggest currency reserves and funds are in countries whose political and value-based systems are being viewed in another light amid today's new security policy landscape. Some 55-60 per cent of global currency reserves, worth about 13 trillion dollars, are invested in dollars and about 20 per cent are invested in euros; only 2.5 per cent have been invested in Chinese yuan.

"Security policy vulnerabilities must be exposed, and financial and technological dependency relationships must be identified."

Both trade and capital flows may change direction due to the risk of assets being frozen or of requirements from customers or authorities that no money may be invested in – or no trading may be conducted with – countries that do not share the same human rights values, rule of law principles or other principles of the international community, or that do too little to tackle the climate crisis. This implies changes in the structure and stability of the international monetary system.

A greater concentration of financial risks, when the opportunity to spread risks is reduced as fragmentation grows, may also increase macroeconomic volatility and the risk of economic and financial crises. Reduced international cooperation on financial stability will also contribute to higher risk premiums and depressed asset prices.

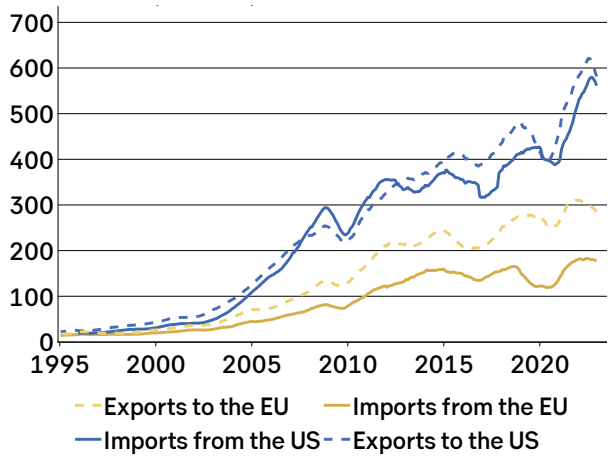
Globalisation versus deglobalisation

Achieving stable, predictable and sustainable earnings now needs to be included as an important parameter in economic decision-making. The question is whether this can be achieved without jeopardising the continued positive results that a globalised, integrated world produces. Increased geoeconomic fragmentation has the potential to add to the supply shocks generated by the pandemic and the war in Ukraine.

Security policy vulnerabilities must be exposed, and financial and technological dependency relationships must be identified. When geostrategic and geopolitical aspects become part of economic policy decision-making, there is a significantly higher risk of less efficient production, worse resource allocation and rising costs.

China's explicitly stated goal – which is shared by such countries as India and Russia – is to reduce the role and influence of the West and especially the United States on the global economic, financial and security policy agenda. At the turn of the year China's president, Xi Jinping, reiterated that Beijing and Moscow should deepen their coordination and collaboration in international affairs. He also noted the ideological affinity between China and Russia as well as their dissatisfaction with US leadership of the West. The growth of populism in the US and Europe has also contributed to this development.

China's trade with the US and the EU



Source: China General Administration of Customs (GAC), Macrobond, SEB

China plays a significant role in global trade, especially for the United States. Further steps towards fragmentation, and reduced trade, may have major consequences for economic growth and costs.

Six centrifugal forces

One can draw a picture of this new world, with different geographic trading blocs built up around six "centrifugal forces". The first force involves shared values and ideologies – that is, future trade will be determined to a greater extent by countries – political leaders and companies – sharing values and political ideologies. The second force is focused on political systems. Pessimists maintain that the "the future of democracies" in general will be increasingly questioned on account of various domestic political events, for example, in the US and the EU during 2021 and 2022.

The US dollar's historical dominance of financial markets and its prominent role as a so-called reserve currency are disliked by various emerging markets, led by China, India and Russia. As the global economy evolves, it is also reasonable to have a more multipolar currency system. The third centrifugal force is thus focused on reserve currencies and the ambition to make the world more dependent on the Chinese yuan. The fact that US and EU sanctions against Russia during 2022 have also involved excluding Russian banks from the SWIFT international payment system has raised the question of whether future trade flows using China's payment system may be the fourth centrifugal force.

The last two forces that may contribute to increased fragmentation and the division of the world into trade blocs – technology standards and trade policy – will also create growing challenges for international companies, which will be forced to manage different systems dependencies, based on their geographic presence.

Global systemic crises over the past three years and other structural forces have created tectonic shifts in the global playing field. This is something that companies, households, political leaders and central banks need to respond and adapt to. Such changes will have consequences – among other things for economic growth, the profitability of companies, global debt and the international monetary system.

What continues to be an extremely serious security policy situation will most likely play a major role in what the future will look like. A carbon-neutral world will not be possible without rapid technological solutions. These, in turn, will depend on access to knowledge, materials and people. Fragmentation is thus a serious threat not only to economic prospects but also to our ability to tackle the crisis of climate change and biological diversity.

US climate plan splits the world

The world is divided over the US Inflation Reduction Act (IRA) – which includes a historic, far-reaching USD 369 billion climate package; see the theme article "US climate policy: Finding balance between competition and EU-US cooperation" in the January 2023 issue of *Nordic Outlook*. Researchers give President Joe Biden's green policy the thumbs up. It is also a policy focused on "carrots" rather than "sticks" to enable the US to achieve its climate goals.

The US is now showing welcome, concrete leadership on the climate issue. The apparent goal of the IRA is to make American green energy and technology an important future export product, reduce US dependence on other countries (increase strategic autonomy) and generate more green jobs at home.

But the package is also part of an industrial and trade policy that gives domestic manufacturers competitive advantages in ways that violate World Trade Organisation (WTO) rules. After extensive criticism from the European Union, the Biden administration has made minor concessions, but the package remains in force. The political balance in the US Congress makes major changes in the package difficult.

The EU has launched its own green policy, but it is not enough. A global race to develop green technology is welcome in the ongoing climate crisis. But if the world is now moving towards greater geoeconomic fragmentation, this decreases the chances that green technology transfer can help solve the climate crisis. Our conclusion is that the EU must build on its own industrial and climate policy.

The need for continued good transatlantic relations in an increasingly strained geopolitical situation means that it is now up to the EU to increase its attractiveness and competitiveness. But achieving maximum global exchanges of green technology and transition strategies will require coordination of climate, industrial and trade policies. Political leaders will also need to ensure that large industrial subsidies and domestic production requirements lead to the right mix and balance between competition and collaboration, without further fuelling protectionism.

Global fragmentation: Winners and losers

The reassessment of economic, financial and security policy relationships described in the previous theme article will affect nearly every sector and create both risks and opportunities for many Swedish companies. Overall, there is a clear risk that this will have negative effects on most global companies. But some will be affected more than others, and not just negatively. We have listed a number of companies that will benefit from this transition, but also companies that will have a much tougher time in a new geoclimate.

One consequence of global fragmentation is the establishment of more local value chains among companies in an effort to reduce their vulnerability. Other consequences are a greater need for self-sufficiency in energy and key input goods, such as critical metals and semiconductor technology. Another repercussion is that, given more regional variation in technology standardisation and regulations, there may be a risk of a decline in technology transfers and an increase in development costs. The majority of large Swedish international companies have tackled the problems that have arisen over the past three years in an impressive way. Despite component shortages, sharply higher costs, absences due to illness, flexible workplaces, lockdown effects in China, the divestment of often lucrative operations in Russia and related impairment losses, profitability has remained high. While Swedish companies have weathered the situation well, there continues to be a need for rapid adjustments and flexibility.

The mining sector will benefit from the ambition to increase Europe's metals self-sufficiency

Metal prices have trended upward in recent years, given the combination of falling metal content in the ore extracted at many existing mines and mining companies' focus on cash flow, with limited investments in new capacity. A clear electrification trend in passenger cars is boosting demand for metals such as copper and nickel. Few permits have been issued for new mines in Sweden, and there are long lead-times between the submission and approval of such an application. If political leaders and decision makers consider it strategically important to increase the critical metals supply in Europe, this may lead to proposals to make permitting processes easier. Such changes should benefit Boliden and increase the likelihood of profitable new mines like the company's copper mine in Laver, Sweden. Suppliers of mining equipment, such as Sandvik and Epiroc, will also benefit if mining companies increase their investments in new mine projects.

Increased sales potential for defence companies, but also changes in risk

Most European countries have reassessed their military defence investment levels after Russia's invasion of Ukraine. So far, most increases in investments have consisted of aid to Ukraine in the form of weapons, ammunition and military training. NATO's previous target was for its member countries to invest 2 per cent of their gross domestic product in defence. Countries bordering Russia invest even more than this. In Sweden too, there is also a discussion about whether 2 per cent should be considered a floor rather than a ceiling. This is a significant change. Listed companies such as Saab, Kongsberg and Mildef would be favourably affected by increased defence spending, since this boosts their long-term sales potential. A need for increased capacity may also affect the structure of new project contracts. This may lead to a smaller percentage of fixed-price contracts and a higher percentage of advance payments, which may affect companies' operational and financial risks.

Increased demand for manufacturing services in electronics

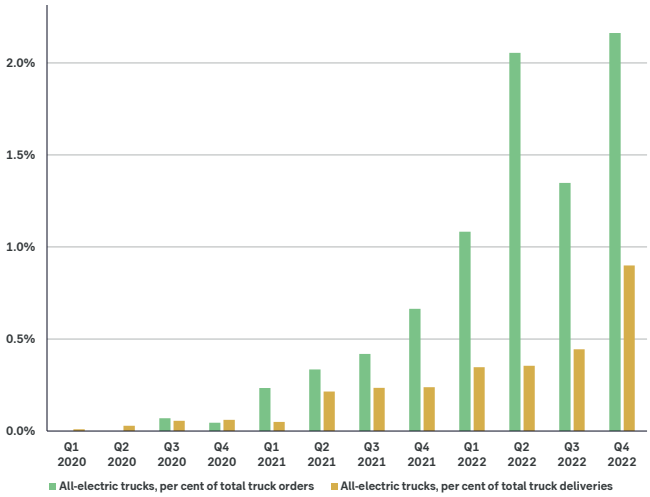
Contract manufacturers of electronics, such as Note, have seen growing demand for their services in recent years. An increased proportion of electronics in most products benefits this sector. Fast-growing companies prioritise investments in the development and sale of new products and choose to outsource production to external partners. Both Finnish-based Incap and Swedish-based Inission have also communicated a positive view of their future growth opportunities. A high degree of automation in production facilities and the relocation of production back to Europe have improved their prospects.

Volvo and Traton may benefit at AP Møller Mærsk's expense

Global supply chains as we know them today will be affected by fragmentation. If companies decide to increase value creation in every region to reduce disruption risks that affect deliveries from other parts of the world, this will change transport flows. It may mean that future economic growth will not affect the demand for container shipments from Asia to the rest of the world to the same extent as before, which may adversely affect the outlook for the Danish-based shipping company AP Møller Mærsk. Deliveries from China may be replaced by flows of goods from cost-effective countries close to the US and Europe, or by highly automated local production. One example of increased deliveries in nearby areas involves the Swedish logistics company Elanders, which noted at the time of its year-end 2022 report that it has seen vehicle customers buy more components from other European countries in order to reduce their dependency on Asia. Another example is that some computer manufacturers have announced that they intend to stop using chips made in China by 2024.

This should stimulate an increase in logistics operations such as road haulage, which offers greater flexibility than rail transport. Such a development would favour the outlook for heavy vehicle manufacturers Volvo and Traton (a subsidiary of Volkswagen that includes Scania). The environmental argument for rail transport is weaker if truck emissions are reduced, since the ambition of vehicle manufacturers and logistics companies is to sharply increase the proportion of electric vehicles (EVs) in their fleets. At Volvo, all-electric trucks accounted for 0.5 per cent of deliveries last year and 1.5 per cent of new orders. This is a positive trend from low levels; see the chart below. Volvo's ambition is for EVs to account for at least 35 per cent of its vehicle sales by 2030.

All-electric trucks as a share of Volvo trucks



Source: Volvo, Macrobond, SEB

The above chart shows all-electric trucks as a percentage of quarterly truck orders and deliveries at Volvo.

Increased automation

As we wrote in the last issue of *Investment Outlook*, improved technology is creating new conditions as more and more things are connected to sensors and software. This increases the potential for more cost-effective and less labour-intensive solutions. Two companies that are well positioned for the Fourth Industrial Revolution are ABB and Hexagon. Their products create the conditions needed for profitable investments in advanced economies, which are then able to compete with companies and regions that have more cost-effective labour.

Energy saving is an important part of reducing vulnerability

Along with a need for new energy sources and a transition to sustainable energy systems, energy efficiency improvements are also necessary to reduce vulnerability in Europe. With high energy prices, investments in energy-saving solutions are increasingly attractive. Swedish companies that will benefit from this include Alfa Laval and Nibe.

Increased tensions are already affecting companies today

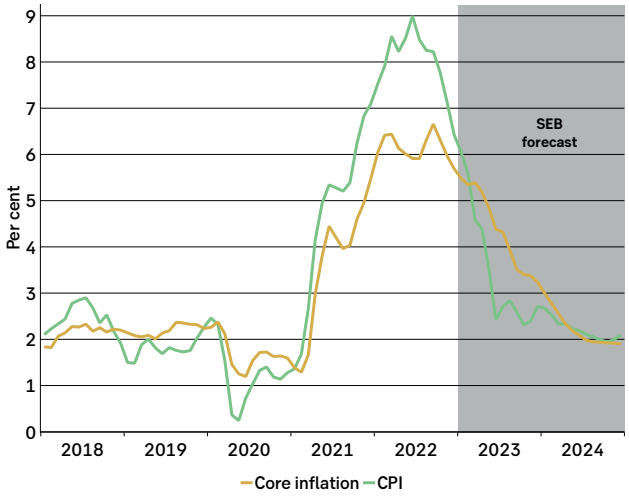
Two Swedish companies that have been adversely affected by a shift in the retail and technology sectors between the US, the EU and China are the fashion retailer Hennes & Mauritz (H&M) and the telecoms specialist Ericsson. The position of these companies in China has deteriorated as a result. Ericsson has managed to offset this because Chinese vendors have largely been excluded from 5G networks in many Western countries; it has thereby enlarged its market share outside China. Another future risk is that global technology standards will be replaced by regional differences and regulations. That might increase Ericsson's development costs and/or decrease its patent revenue as well as its global economies of scale. Hennes & Mauritz has chosen to shift its purchases from areas where supplier corporate social responsibility (CSR) practices are questionable. This has had a negative impact on its revenue in China.

With increased global fragmentation, there is a risk that companies' economies of scale will decrease. That means a change in sales will affect earnings to a lesser extent when companies enter new markets or expand their range of products and services. With a larger number of regional production structures, adjustment capability may also be affected by changes in market conditions. This may result in continued problems like those experienced today by many companies that have needed to help certain suppliers hit by rapid cost increases and have had to raise the prices paid by their customers to avoid a decline in profitability. Overall, there is a risk that margins will be squeezed after a long period of growing profitability for many companies, which have benefited from strong global economic growth. Increased fragmentation is thus likely to have a generally negative impact on most companies with global market positions.

Theme: Inflation
Increased hopes of much lower inflation

After nearly two years of rising and surprisingly high inflation, the prospects of lower inflation are now much better. There are still many question marks as well as growing differences between regions. The clear downturn in inflation in the US, which was the first country to see the upturn, increases the likelihood that inflation will also fall globally.

US inflation has peaked



Source: BLS, Macrobond, SEB

The chart shows the consumer price index (CPI) and CPI excluding energy and food, so-called core inflation. Over the past three to six months, there have been signs that inflation may have peaked in the United States. Core inflation has fallen by 2.5 percentage points to about 6.5 per cent since June last year.

Strong demand for goods, alongside production and transport disruptions, drove up inflation

In our view, what triggered high inflation was extremely expansionary US fiscal policy. Large stimulus payments to households helped increase goods consumption by 15-20 per cent in just a few months. Supply and transport disruptions, both in the US and globally, helped accelerate the upturn. There were huge price increases for energy and commodities as well as manufactured goods. After a lag, the upturn in inflation became global, with the war in Ukraine helping to drive inflation even higher, especially in Europe.

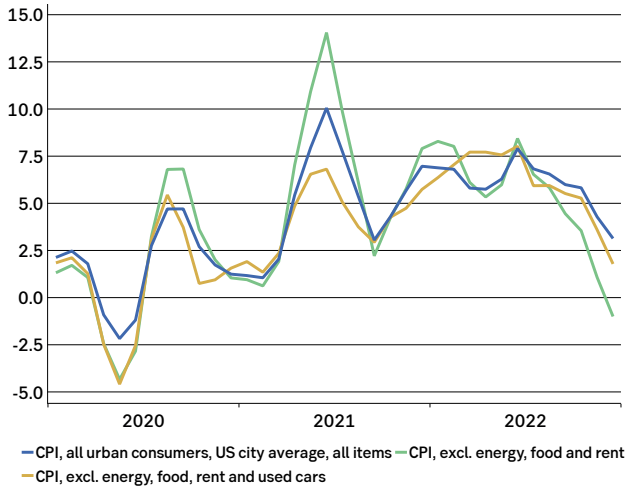
Much lower US inflation

Over the past three to six months, there have been signs that inflation may have peaked, especially in the US, where CPI inflation has fallen by 2.5 percentage points to about 6.5 per cent since June last year. Falling energy prices are the most important driver, but over the past three months core inflation (CPI excluding energy and food) also slowed by nearly one point to 5.7 per cent. While still well above the US Federal Reserve's 2 per cent target, there are many indications that inflation will continue to ease. Over the next three to six months, the big energy price hikes during the first six months of 2022 will disappear from rolling twelve-month figures. Unless there is a new energy price shock, CPI inflation looks set to fall below 2.5 per cent as early as this summer.

Lower core inflation in the US despite sharply higher rents

The core inflation trend is not as clear, but monthly changes over the past three months have averaged around 0.3 per cent, compared to the 0.5 per cent monthly increases posted during the first three quarters of 2022. The composition of price changes also indicates that an even greater slowdown in core inflation may be in store, since large rent hikes are currently adding nearly 0.3 percentage points a month to core inflation.

Lower US core inflation



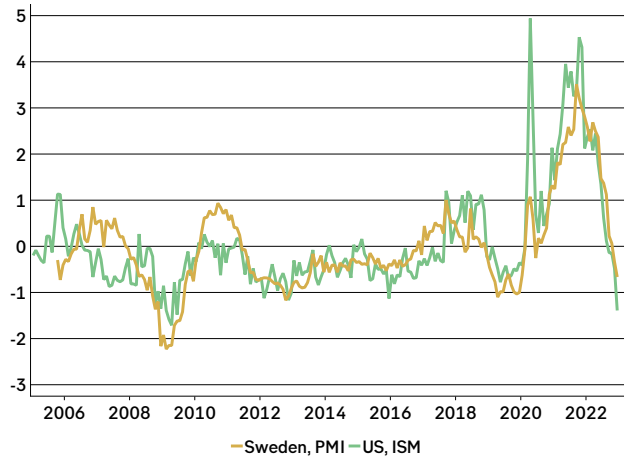
Source: BLS, Macrobond, SEB

Core inflation has been propped up by large rent hikes and used car prices. The latter component will fall, since comparative figures from spring 2022 were very high.

Stagnating rents in 2024?

If rents are excluded, core inflation has been negative for three straight months. Except for the price declines during the pandemic, this is the lowest core inflation during a three-month period since at least 1980. As part of CPI, rents will continue to increase at a rapid pace at least for the next three to six months, but rents in new leases look set to stabilise. If this trend continues, it means that in 2024 rents as part of CPI will fall below their historical trend. Falling prices for goods, especially used cars, are one key explanation for low core inflation in recent months, and there are indications that goods prices will continue to fall, reversing some of their increases. Goods consumption has fallen gradually since mid-2021, and the production bottlenecks that contributed to the upturn in inflation have eased significantly. Both delivery times and price changes in the purchasing managers index (ISM) are now well below normal levels. US hourly earnings are still probably increasing at a faster pace than is compatible with the Fed's inflation target in the longer term, but there are some deceleration tendencies here as well. If the labour market weakens in line with our forecasts, slower wage and salary growth is also likely.

Bottlenecks have eased



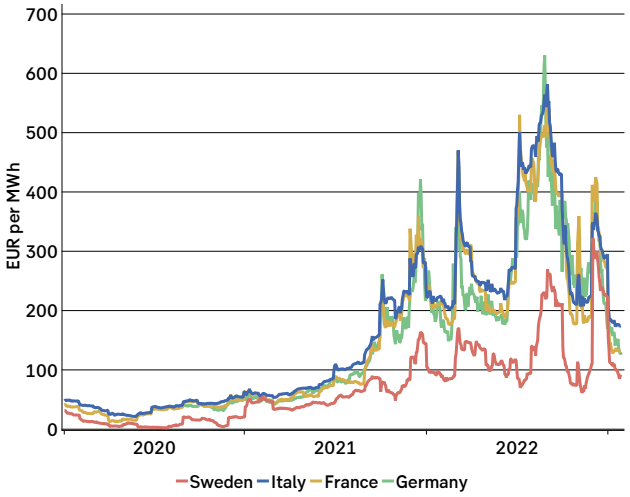
Source: Swedbank, ISM, Macrobond, SEB

The chart shows delivery times based on purchasing managers' indices (PMIs) for Sweden and the US (the ISM Manufacturing and Non-manufacturing surveys), which have now fallen below normal levels.

European energy prices have fallen significantly but are still high

Steep falls in electricity and natural gas prices suggest that inflation in the euro area is heading downward. However, the inflation outlook in Europe is more complicated and, unlike in the US, electricity and natural gas prices are still much higher than before the pandemic. Many countries have used subsidies, taxes and price controls to keep prices down for households and businesses. Energy prices as part of the consumer price index (CPI) will probably not follow market prices downward to any great extent. Given high energy prices, there is still a great risk that core inflation will be much higher in Europe than in the US, when businesses try to compensate for increased costs.

European energy prices still high



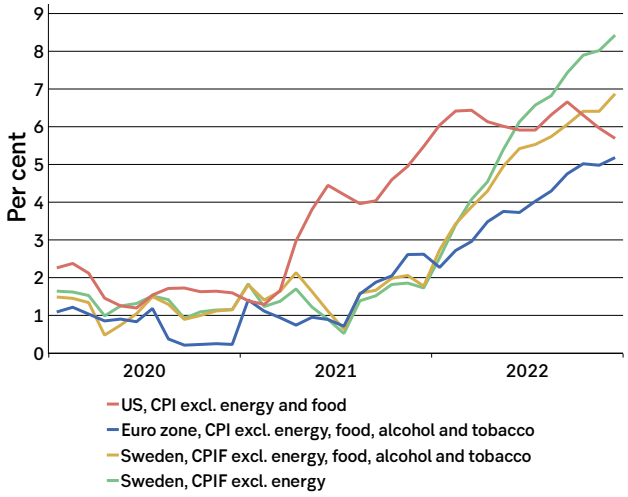
Source: Macrobond, SEB

European energy prices have plunged but are still far higher than historically.

Core inflation is still rising in Europe

Core inflation in the euro area continued to rise late in 2022, and a very large percentage of companies in retail and other consumer-oriented sectors plan to raise their prices over the next few months. In Sweden, CPIF excluding energy, food, alcohol and tobacco – a core inflation metric that aligns with the most common such metric in the euro area – rose to 6.9 per cent in December after remaining unchanged at 6.4 per cent in November. The weak Swedish krona is contributing to relatively higher inflation in Sweden, but core inflation in the euro area also hit a new high in December: 5.2 per cent.

Rising core inflation in Europe

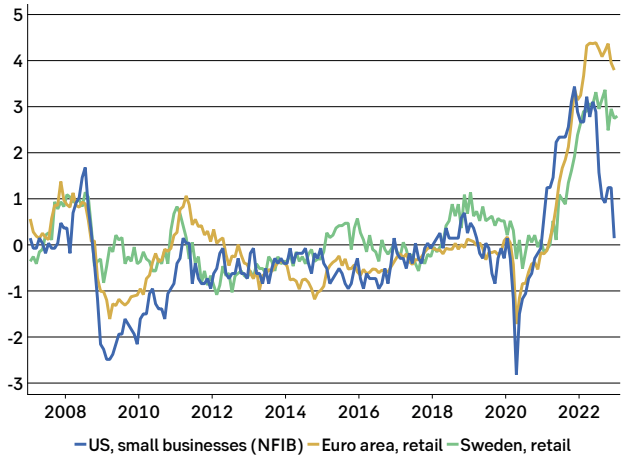


Source: BLS, Eurostat, Statistics Sweden, Macrobond, SEB

The downturn in US inflation, like the expected downturn in the euro zone and Sweden, is being slowed by high core inflation. Core inflation is still rising in the euro zone and Sweden, but subdued pay increases are pointing in a favourable direction.

There are some encouraging signs of decelerating inflation in the euro area as well, with reduced delivery times and decreasing price pressure on input goods and in manufacturing. However, unlike in the US, companies say that prices are still rising faster than normal. Base effects of high price hikes in 2022 also suggest that core inflation will gradually slow, but signals of falling inflation are much weaker than in the US so far. However, one favourable factor for long-term inflation is that wage inflation has accelerated much less than in the US. This is especially true in Sweden, where wage and salary growth is still just below three per cent, despite high inflation expectations and a tight labour market. There is also an increasing probability of moderate pay increases in the current national collective bargaining negotiations, though some uncertainty remains.

Easing price pressure in Europe, but far behind the US



Source: NFIB, European Commission, NIER, Macrobond, SEB

Price expectations according to business surveys have peaked. As with overall inflation, the US is leading the way. Levels remain high in the euro area and Sweden.

Lower inflation in the euro area, too, is the likeliest scenario

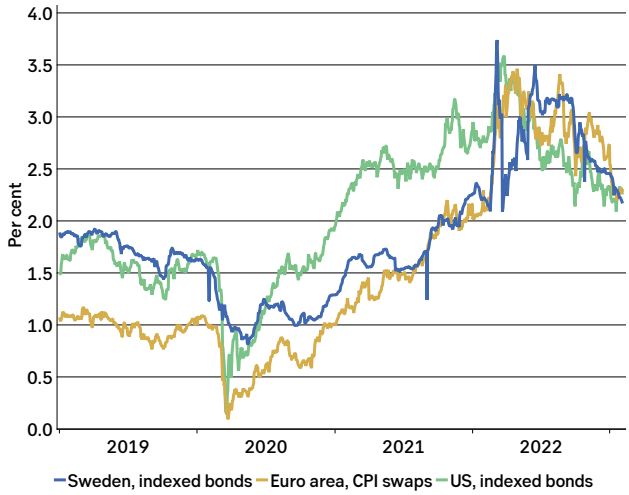
Clearly decelerating US inflation increases the likelihood that our forecasts of falling euro area inflation will prove accurate, although there are greater upside risks for core inflation over the next six months. In most countries, the post-pandemic inflation upturn was by far the biggest since the early 1980s, and forecasts are still much more uncertain than usual. Because of the war in Ukraine, new energy and commodity price surges are possible, and given the geopolitical situation the outlook for supply chains and globalisation remains uncertain. The green energy transition and wage developments are other upside risks, especially if economic growth does not slow in line with the forecasts of SEB and others. Although the risks of a repeat of 1970s-style inflation have decreased, it may be important to remember that inflation during the 1970s was not only high but also highly volatile.

Not all risks are on the upside

On the other hand, not all inflation risks are on the upside. One not entirely improbable scenario is that some price increases from recent years will be reversed, which could cause inflation to fall below target or be followed by a period of deflation. Apart from commodities, no clear signs of widespread price decreases are as yet discernible, but container freight prices, which increased sevenfold during the pandemic, have nearly fallen back to their 2019 levels. Some big US price hikes for used cars have been reversed, and certain manufacturers of new cars have announced that they are now lowering their prices. Historic inflation upturns have often been followed by periods of low inflation, but it is unusual for prices to fall, except for energy and in some cases food.

Our forecast is that inflation will fall below central bank targets in 2024, though this is partly due to some normalisation in energy prices. Market inflation expectations based on inflation-indexed bond yields and CPI swaps gradually eased in 2022, and these expectations are now in line with inflation targets, although they are higher than pre-pandemic levels.

Expectations in line with the inflation target



Source: Bloomberg, Macrobond, SEB

The chart shows that market inflation expectations based on inflation-indexed bond yields and CPI swaps fell gradually in 2022, and levels are now in line with central bank inflation targets, although they are higher than before the pandemic.

International overview

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

Mild recession, despite aggressive central banks

High inflation and rising interest rates will finally take their toll, and a recession will arrive during 2023. Inflation has now fallen and Europe's energy supply situation has improved markedly, which will help make the recession milder than feared. China's earlier-than-expected reopening is also positive, and its economy will accelerate in 2023. Global downside risks are mainly linked to underestimation of interest rate sensitivity. Looking ahead, a clearer decline in inflation may create room for positive growth surprises.

The global economy showed continued resilience well into 2022. Although households have been squeezed by rising interest rates and high inflation, consumption has held up relatively well. Partly due to the desire to return to a more normal life when COVID-19 restrictions are gone, a significant share of the savings buffers built up during the pandemic has been spent. Businesses have benefited from an easing of global supply disruptions as well as continued relatively healthy demand in many areas. A recent decline in energy prices has also reduced cost pressures. GDP growth in 2022 thus looks set to turn out stronger than we had expected in most countries.

Mild recession during 2023

In recent weeks, leading indicators have weakened in such a way that a mild recession in early 2023 is still likely. Household buffer savings are starting to dry up, and confidence indicators in the business sector have fallen to levels suggesting some decline in output. But the delay in the downturn has contributed to some upward adjustments in our full-year 2023 GDP growth forecasts for both the United States and Western Europe. Despite short-term problems in China with widespread virus transmission, the lifting of COVID-19 restrictions has also made it possible to revise Chinese GDP growth upward. A general increase in central bank hawkishness is delaying a rebound – one reason why we have instead revised our 2024 GDP forecasts downward.

Global GDP growth, %

Market	2021	2022	2023	2024
United States	5.9	2.0	0.5	1.2
Japan	2.1	1.9	1.8	1.3
Germany	2.6	1.8	-0.3	2.4
China	8.1	3.0	5.5	4.9
United Kingdom	7.6	4.0	-1.2	0.7
Euro area	5.3	3.4	0.0	1.9
Nordic countries	4.4	2.6	-0.3	1.7
Sweden	5.1	2.9	-1.2	1.1
Baltic countries	5.9	1.4	0.2	3.3
OECD	5.7	2.9	0.7	1.7
Emerging markets	6.7	3.7	3.9	4.5
World, PPP*	**6.0**	**3.3**	**2.5**	**3.3**

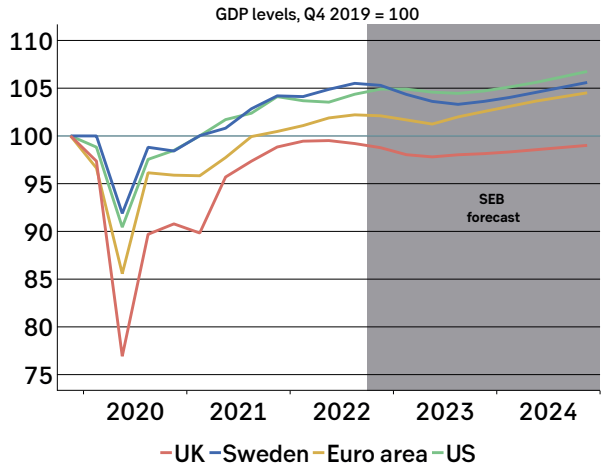
Source: SEB Nordic Outlook

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

The respite has reduced the likelihood of a deep crisis

Behind the relatively small revisions in our forecast figures are big changes in the risk picture and in the interactions between the performance of the real economy, economic policies and financial markets. Resilience in 2022 helped us to avoid a situation where the economy entered a recession while inflation was on the rise. Such a "perfect storm" would have been even harder for central banks to deal with. This would have triggered a scenario of severe stress symptoms in the financial system, with credit tightening further reinforcing the downturn in the real economy. The time we have now gained has consequently reduced the risks of a deep recession. This is reflected, for example, in the rising share prices of recent months.

Mild recession ahead



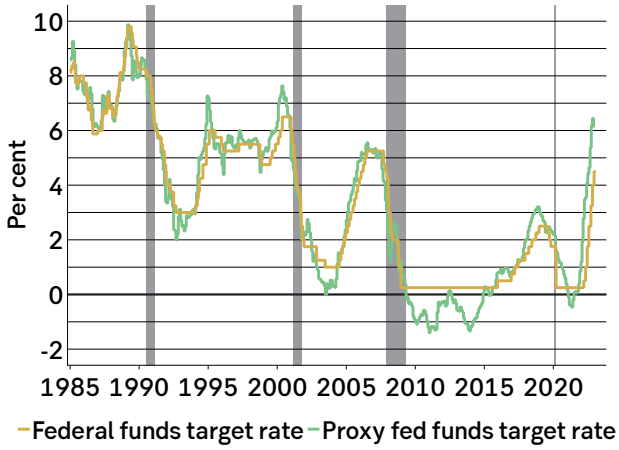
Source: Macrobond , SEB

We expect weak negative growth during the next few quarters, especially in the United Kingdom, where the recovery has also been weaker.

Central banks have become more hawkish

Meanwhile, economic resilience has been one reason why central banks have signalled that they need to do more to bring inflation under control. Raising the stakes in this way makes the timing of the growth slowdown and of the decline in inflation especially important. We see various reasons why the inflation outlook has improved in the slightly longer term, and why the risks of a wage-price spiral like that of the 1970s have thus faded. The energy market outlook for the next couple of years now seems better, while freight prices have tumbled and agricultural commodity prices have fallen. In Europe, especially the Nordics, wage responses to inflation also suggest that a wage-price spiral is unlikely. But the decline in core inflation will probably be so sluggish that central banks will feel justified in carrying out their plans for aggressive tightening in the near term.

Central banks have become more hawkish



Source: Federal Reserve Bank of San Francisco, Federal Reserve, Macrobond , SEB

In addition to interest rate hikes, today's monetary policies include tightening via reductions in central bank bond portfolios (quantitative tightening or QT) and forecasts of further interest rate hikes. In the US, the overall impact is described as the "proxy" fed funds target rate and is equivalent to about 6.5 per cent.

Has interest rate sensitivity been underestimated?

The shift to aggressive monetary policy increasingly seems to be the main downside risk in our forecast, especially considering the lengthy time lag before rate hikes have an impact on the economy. Before the global financial crisis, for example, the US Federal Reserve raised its key interest rate by 4.25 percentage points over a period of just over two years. Now the Fed is hiking its key rate more than that in less than one year, and its speed is now more in line with its austerity measures of the 1970s. In addition, the Fed has shifted from being a net buyer of securities to slimming down its balance sheet (moving from quantitative easing, QE, to quantitative tightening, QT). According to calculations by the San Francisco Fed, the actual tightening effect has been around 2 percentage points above that of the key rate. In Europe there are also similar risks, although key rates are not expected to reach such high levels as in the US.

Weak economies with high public debt in southern Europe and highly leveraged households with a large share of variable-rate borrowing in Sweden and Norway are especially vulnerable. Yet today's inflation environment is holding down real interest rates, suggesting that the tightening may not be so severe. This might help explain the resilience shown by both businesses and households.

Faster inflation slowdown conceivable

The potential for more favourable economic performance lies mainly in inflation falling faster than according to the current consensus and our main forecast. The rapid dynamic of the upturn phase may be replaced by its mirror image, as the large price gains of spring 2022 begin to vanish from the 12-month figures. Meanwhile actual declines are conceivable in areas where price levels have been the most extreme, mainly in the energy field. Very recently, there has been anecdotal information about a sharp decline in input costs for many companies. We are still choosing to interpret this cautiously, while awaiting more reliable signals from business surveys. A faster decline in inflation would directly ease pressure on households as well as open the way for looser monetary policies, which in turn would provide support for a solid stock market upturn. We believe that the risk picture concerning the growth outlook is now symmetrical after a rather long period dominated by downside risks.

Various scenarios for the OECD countries

GDP growth, per cent	2022	2023	2024
Main scenario	2.9	0.7	1.7
Negative scenario		-1.5	0.0
Positive scenario		2.0	3.2

Source: SEB

Bond yields have peaked

Our financial conclusions are based largely on the above risk analysis and timing issues regarding central bank hiking cycles as well as GDP and inflation developments. Because of more favourable inflation signals, bond yields have come down from the peaks recorded last autumn. In the short term, the tough attitude of central banks means that we foresee the potential for a slight rebound. After that, long-term yields will fall again as the inflation downturn becomes more pronounced and the market focus shifts from key rate hikes to future rate cuts. We expect the yield on 10-year US Treasury securities to fall gradually to 2.80 per cent by the end of 2024. We believe the Riksbank is likely to start actively selling government bonds this autumn, which will put upward pressure on yields.

Krona weakness despite more favourable conditions

The euro has recovered unexpectedly fast due to lower US inflation figures and improving European energy supply. A downward correction in the EUR/USD exchange rate is likely during the rather turbulent period we foresee in the near term. After that, the EUR/USD rate will continue to move towards levels that are more justified by fundamentals, reaching 1.12 by the end of 2024. Despite various favourable factors, including improved risk appetite, the Swedish krona has remained weak. The European Central Bank's tough signals and market worries about the Swedish housing market are probably among reasons why the EUR/SEK rate remains high. Over time, economic recovery and low valuations will help the krona appreciate a bit. We believe that EUR/SEK will be slightly above 10 by the end of 2024. A rebound in oil prices will help the Norwegian krone appreciate a little earlier. We expect the EUR/NOK rate to reach 10 by this summer.

The stock market has reacted positively to the brighter inflation outlook after a dismal 2022

Given the expected slowdown in economic growth, we see a major risk of downward revisions to 2023 earnings forecasts, which implies risks of a stock market correction in the near term. But investors have probably priced in lower corporate earnings already, at least in part, and are now starting to look further ahead towards the next phase. Assuming that our main scenario proves correct, we expect global stock indices to deliver a reasonably good return – above the historical average of 5-7 per cent.

Protectionist threats in new climate policies

After more than a year of negotiations, US Congressional Democrats managed to agree in August on a slimmed-down version of Joe Biden's election promises on climate, energy, health care and taxes. The name of the Inflation Reduction Act (IRA) is actually misleading, since the package is not expected to have any major impact on inflation. Yet the new law has triggered strong reactions. The US is thereby assuming greater climate responsibility, which is positive. But meanwhile the law includes clear steps towards a more protectionist US industrial and trade policy, by reducing costs of domestic production and development of green energy technology. The IRA will thus exacerbate the risks of fragmentation in the global economy following the COVID-19 pandemic and amid an increasingly tense security policy situation.

European countermeasures on the way

European Union business representatives have warned that the IRA could lead to European de-industrialisation due to the current energy crisis. After extensive criticism from the EU the Biden administration has made some minor concessions, but they hardly change the main thrust of the new law. As a result, the EU will face difficult challenges in developing its own industrial and climate policy. It is important to strike the right balance between ensuring the competitiveness of EU industry while maintaining good transatlantic cooperation to avoid an escalating trade war that would worsen geopolitical tensions.

China's reopening will fuel higher growth

Protests against COVID-19 restrictions and an economic slowdown during 2022 finally persuaded Chinese authorities to reverse their COVID policy. The reopening of society occurred faster than expected. We forecast that GDP growth will reach 5.5 per cent in 2023 and 4.9 per cent in 2024. This is a strong recovery compared to 2022. There are also upside risks to our forecast. Expansionary fiscal and monetary policies, support for the crisis-hit real estate sector, large accumulated household savings and pent-up consumption needs after large-scale lockdowns suggest a solid economic take-off in 2023. But the reopening is not without its complications. Virus transmission rapidly accelerated when restrictions were lifted during Q4 2022. Among other things, this has put pressure on the health care system, which is struggling to cope with the surge in demand. While it may be a little too early to declare victory, the worst fears of massive absenteeism from workplaces and new problems for global value chains appear not to have materialised.

A moderate rise in inflation

China's reopening has led to greater inflationary pressures as demand in some areas has outstripped supply. With an eye to earlier Chinese inflation patterns, hoarding during the pandemic and the ability of authorities to regulate price increases, we have revised our 2023 inflation forecast upward to a rather moderate 3.0 per cent from the previous 2.1 per cent. A larger increase in inflation, which would trigger more restrictive economic policies, nevertheless poses a certain downside risk to our GDP growth forecast.

GDP growth, BRIC countries and EM sphere
(year-on-year percentage change)

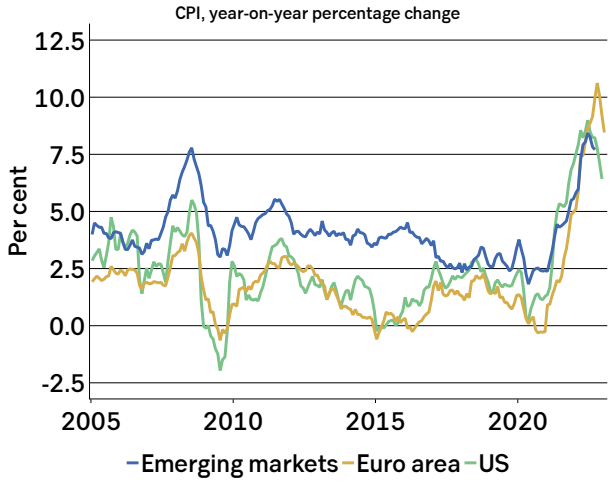
	2021	2022	2023	2024
China	8.1	3.0	5.5	4.9
India	8.7	6.8	6.0	6.2
Brazil	4.6	3.0	0.8	2.0
Russia	4.7	-4.0	-3.0	1.5
EM economies, total	6.7	3.7	3.9	4.5

Source: IMF, SEB

Slowdown in other EM economies

Other major emerging market economies will instead decelerate in 2023 because of weaker global economic conditions. Growth will also be hampered by tighter financial conditions due to rising interest rates and a strong US dollar, as well as a generally lack of room for stimulus measures. Energy and other commodity prices have fallen from earlier peaks. This levels the playing field a bit between commodity exporters and other EM countries. Sanctions due to the Ukraine war will continue to weigh on the Russian economy, but the decline in GDP will still be modest. Since the economies of China and other EM countries are moving in different directions, GDP growth in our EM sphere will end up about the same in 2022 and 2023, followed by an acceleration in 2024.

Modest inflation upturn in EM sphere



Source: Macrobond, SEB

Thanks to relatively quick monetary policy actions and less dependence on natural gas (than Europe), inflation in EM economies has turned out to be significantly milder than initially feared.

Inflation on its way down

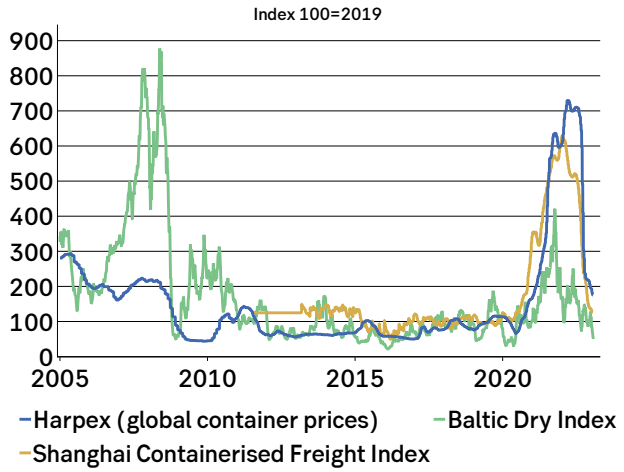
The inflation upturn in EM economies has been milder than previously feared, given the greater relative weight of food and energy as well as the higher underlying trend compared to more developed countries. Just as in the US, inflation in the EM sphere has peaked and is on its way down. There are various reasons why inflation has not soared even higher. EM economies were relatively quick to tighten their monetary policies, both for inflation reasons and to prevent their currencies from weakening. In addition, EM countries are less dependent on natural gas than Europe in particular. Many of them have continued to import cheap Russian oil.

A fading energy crisis, but rising prices

The cooling of the global economy caused the prices of oil, coal and natural gas to fall sharply late in 2022. The EU also managed to cope with the impact of exceptional natural gas and electricity prices unexpectedly well. Increased imports of liquefied natural gas (LNG), mild weather conditions and impressive adaptability on the part of manufacturing companies and households enabled the EU to build up its gas inventories to a level around 15 per cent above normal. The crisis has largely faded, and the risk of gas rationing this winter and next is very small. Nevertheless, the global market for fossil fuels is expected to remain tight. The price of natural gas (using the TTF price in Amsterdam) is still three times normal – but well below 15 times normal, which was the level in late August 2022. We expect natural gas prices in Europe to rise somewhat from today's levels, but the annual average for 2023 will still be lower than in 2022.

OPEC has had a challenging period these past eight years, because output growth outside of the oil cartel was very strong. This has now changed. We believe market power will be predominantly in OPEC's hands over the next five years. In light of this, and since sanctions against Russia will cause a significant decline in the supply of oil and gas, we expect the price of Brent crude to rise to an average of USD 110/barrel this year and USD 100/b in 2024.

Freight prices have fallen



Source: Baltic Exchange, Shanghai Shipping Exchange, Harper Petersen & Co., Macrobond, SEB

The production bottlenecks that arose during the COVID-19 pandemic and contributed to the inflation upturn have greatly eased, and freight prices are now largely back at pre-pandemic levels

A tough balancing act for fiscal policymakers

Fiscal policymakers face a difficult balancing act. They must deal with an economic slowdown, but stimulus measures risk making it harder for central banks to fight inflation. International organisations that used to advocate aggressive fiscal policies are now warning that unfunded stimulus measures will create problems. Last autumn's turbulence in the United Kingdom, where an expansionary mini-budget led to rising bond yields and a government crisis, was a cautionary tale.

Public sector fiscal balance (% of GDP)

	2021	2022	2023	2024
United States	-10.9	-4.0	-5.5	-6.5
Euro area	-5.1	-3.9	-3.0	-2.5
United Kingdom	-8.0	-4.3	-2.3	-1.5
Sweden	-0.1	1.2	0.4	-0.7
OECD	-8.2	-4.4	-4.2	-4.3

Source: IMF, SEB

The energy crisis is dominating European fiscal policy

The crisis packages launched in the US and the EU during the pandemic – including a focus on green investments, energy, digitisation and infrastructure – are now providing an investment boost after a certain time lag. There has also been extra defence and security-related spending due to the Ukraine war. The energy crisis is affecting Europe more than other parts of the world economy. It is driving an increase in investments aimed at a long-term transition in the energy landscape but is also creating a need for large-scale subsidies to ease the short-term impact of high energy prices on households and businesses. Germany is now taking advantage of its strong public finances to provide larger subsidies than other countries. This has created tensions, since some countries in southern Europe cannot afford such generosity. Because of political gridlock in the US Congress, major political reforms are unlikely during the rest of Joe Biden's first term as president.

Large differences in electricity price subsidies

The electricity price subsidies that European households are now receiving are softening the downturn. Bruegel, a think tank based in Brussels, has tried to compare the scale of the various national subsidies. The differences between countries are very large. Germany is at the top, with subsidies totalling more than 7 per cent of GDP over a period of 15 months. Also notable is that households in the euro area – as in the case of interest expenses – have energy contracts that significantly delay the impact of price changes in electricity markets. Sweden is at the bottom in terms of the scale of its subsidies, reflecting the long delay in payments. But even under the proposals now presented, Swedish energy price subsidies will be relatively low in international terms. The government's generally cautious fiscal stimulus measures are especially remarkable considering Sweden's fundamentally strong public finances and the fact that this year's GDP downturn looks set to be larger than elsewhere in Europe.

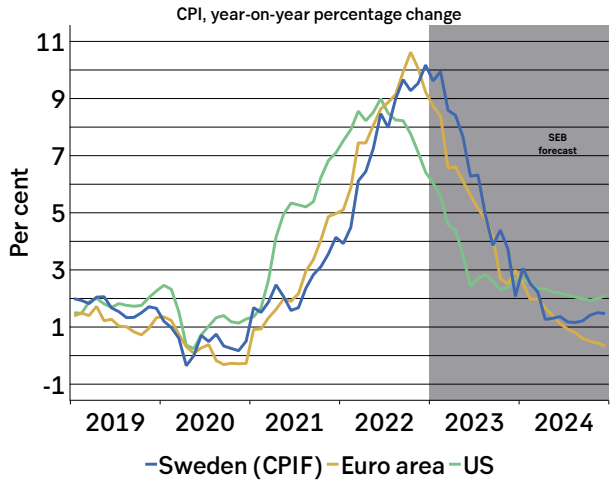
Some easing on the inflation front

Although inflation trends in the US and Western Europe have been a mixed bag, favourable signals have recently predominated. Freight prices are now largely back at pre-pandemic 2019 levels. Overall prices of input goods have also declined, although their levels are still higher than normal, while agricultural commodity prices have stabilised. In the US, inflation has surprised on the downside for three months in a row. Previously large price increases for used cars are being reversed, helping to bring monthly core inflation figures (excluding food and energy) back down to pre-pandemic levels. Headline CPI inflation peaked at 9.1 per cent in June 2022 and was 6.4 per cent in December. We are forecasting that it will fall to 2.5 per cent by June and then stabilise at that level.

In Europe, inflation has reached higher levels than in the US. There is also a significant time lag compared to US trends. Our forecast indicates that the harmonised index of consumer price (HICP) in the euro area peaked at 10.6 per cent inflation in October. The decline in HICP inflation will be relatively sharp in 2023, but the annual average will still end up at a bit above 5 per cent. Falling energy prices will make a large contribution, but there is great uncertainty – partly because different ways

of designing electricity price subsidies have different effects on inflation metrics. *Nordic Outlook* presents an alternative scenario for energy and food price pass-throughs, with HICP inflation falling below zero in early 2024. This indicates downside risks to our forecast in the short term. In Sweden, inflation has kept climbing. CPIF (CPI excluding interest rate changes) reached a year-on-year high of 10.2 per cent in December, partly driven by a weak krona. This is probably the peak, although CPIF will probably be close to 10 per cent in January and February too. After that, a clear decline will begin, mainly driven by base effects as large price increases that occurred in the spring of 2022 begin to disappear from the 12-month figures. By the end of 2023, we expect CPIF inflation close to 2 per cent.

Inflation will fall



Source: Macrobond, SEB

Inflation in Sweden and the euro area are lagging behind that in the US, which has already fallen, but it appears set to follow the same downward trend as US inflation this year.

More sluggish decline in core inflation

Looking ahead, central banks are likely to focus increasingly on core inflation. Euro area core inflation accelerated in December. Its decline is expected to be rather sedate over the next six months. Producer prices for consumer goods are still rising relatively fast, and retailers continue to report plans for sizeable price hikes. This suggests that there is still some inflationary pressure. Rising rents and hikes in various public fees are other contributing factors.

Some moderation in US pay increases

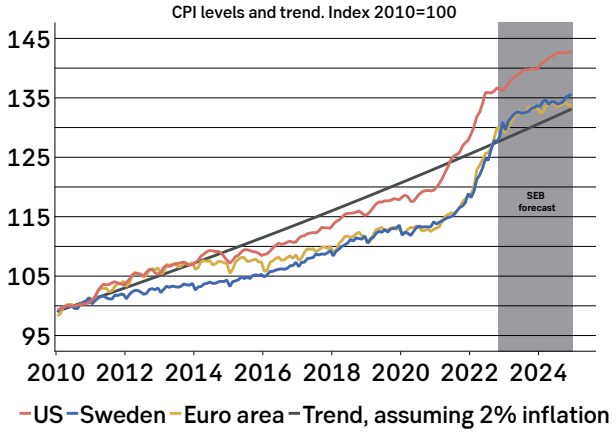
Wage formation is crucial to both actual medium-term inflation and the risks of a long-term shift in the inflation environment. US pay increases in the private sector slowed to a bit above 5 per cent year-on-year. The latest monthly figures reinforce the view that growth has peaked. The tight labour market, with 3.5 per cent unemployment, suggests continued upward pressure on wages and salaries. But we believe that short-term wage growth of 5 per cent will be enough to enable increases to fall to levels that will open the way for key interest rate cuts.

Job vacancies have already started to fall, indicating that concerns about a sharp rise in equilibrium unemployment may be exaggerated.

Depressed real wages in Sweden

In the euro area, pay hikes have also accelerated somewhat, although the rate of increases is slower than in the US. Businesses have generally been able to maintain their profitability relatively well, allowing them room to offer some inflation compensation to their employees. Our forecast is that overall annual pay hikes in the euro area will end up at around 4.5 per cent in 2023 and 2024, which is in line with the outcome of German pay negotiations. Sweden's national wage round is now entering a crucial stage. The negotiating bids that have now been presented suggest that collective agreements will result in slightly lower increases than in the euro area in both 2023 and 2024. We are sticking to our forecast that pay hikes will total 4.5 per cent in 2023, but we have lowered our 2024 forecast slightly to 3.2 per cent. All in all, our price and wage forecasts indicate that real wage growth in Sweden will be somewhat slower than in other countries.

Above-trend price levels after the inflation shock



Source: Macrobond, SEB

After a long period of inflation below the 2 per cent target, because of last year's inflation shock, price levels are now above their long-term trend. They will remain so during the coming year.

Diminishing risk of lingering 1970s-style inflation

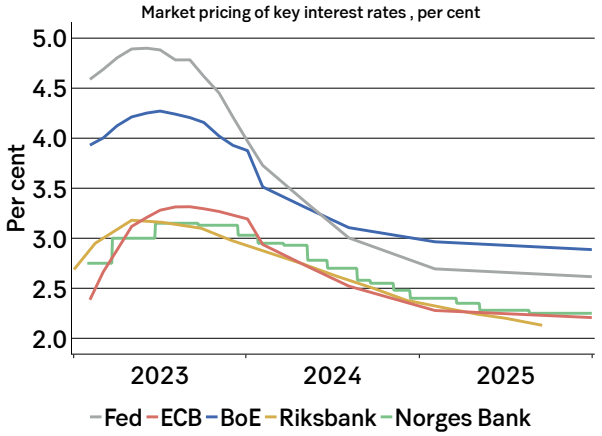
As inflation began to soar in 2022, for a while it became increasingly popular to draw parallels to the stagflation era of the 1970s. But such a development is starting to look increasingly unlikely. Long-term inflation expectations have remained rather close to inflation targets. Pay hikes are accelerating a bit, but a harmful wage-price spiral seems distant. Fiscal policymakers look set to adopt a fairly neutral stance in 2023 and 2024, which also suggests that the mistakes of excessive fine-tuning ambitions during the 1970s will not be repeated. Once contagion effects have worked their way through the system, base effects combined with some normalisation of bloated price levels will push down inflation. This means that actual risks will be more on the downside by the end of 2024 and that inflation may indeed fall well below target for a while.

There are still upside risks in our inflation forecast, but they are instead linked to short-term inertia or traditional overheating risks, mainly in the US and UK labour markets.

The precautionary principle reigns

Most central banks are now nearing the end of their rate hiking cycle in an environment where actual inflation appears to have passed its peak, but where demand and the labour market are showing resilience. But uncertainty about the supply side of the economy, especially concerning the workforce, is among the reasons why central banks are currently being cautious about signalling an end to their hiking cycle. The markets are already pricing in future interest rate cuts, which also creates a need to hold back so that the impact of earlier tightening is not offset by too rapid a decline in long-term yields.

The market is shifting its focus to future rate cuts



Source: Macrobond, SEB

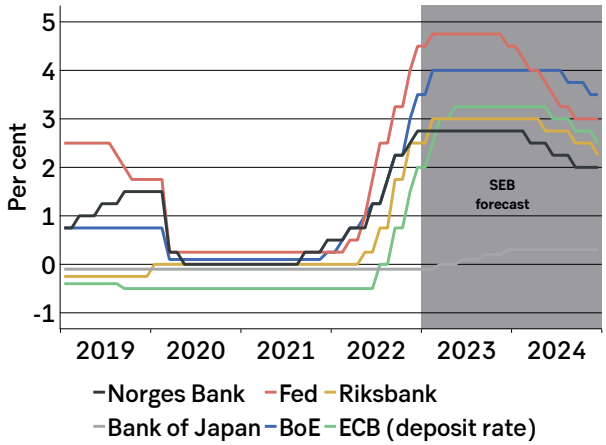
Market players are expecting key interest rate cuts as early as mid-2023. This makes it necessary for central banks to resist such expectations, in order to ensure that the effects of earlier tightening do not unravel.

We are sticking to our forecast that the Federal Reserve will deliver a final rate hike – bringing the federal funds range to 4.50-4.75 per cent – at its meeting in early February. After that, it will leave its key rate unchanged until the end of 2023, when it will gradually begin cutting it to 3.00 per cent by end-2024. This is still slightly above the level that the Fed regards today as neutral. In the short term, there is an upside risk to our forecast, connected to the Fed's rhetoric and its own forecasts of a peak above 5 per cent. We expect the Fed to continue slimming down its balance sheet this year, but at a slow pace whose effect will be quite small compared to changes in the key rate. In line with the previous reduction in the Fed's balance sheet in 2018-2019, we believe that it will pause this process prematurely once there have been significant rate cuts, i.e., during 2024.

The ECB has become more hawkish in response to high inflation, concerns about rising wages and new fiscal stimulus measures in the euro area. We now expect the ECB to raise its deposit rate by 50 basis points at each of the next two meetings in February and March. After a final 25 bp hike in May, the deposit rate will peak at 3.25 per cent. The ECB will start cutting rates again in mid-2024, with the deposit rate reaching 2.50 per cent at the end of our forecast period. The ECB has now also started downsizing its balance sheet, and we expect this process to accelerate during 2023. The Bank of England, like the Fed, will end its interest rate hikes in the first quarter of this year. Even the laggard Bank of Japan has now begun to take small steps towards a less expansionary monetary policy. We expect the BoJ to abandon the negative key rate at its April meeting and gradually raise it to 0.30 per cent by the end of the year. The BoJ is phasing out its bond purchases at a very cautious pace, and its balance sheet will continue to grow throughout our forecast period.

Differences in interest rate sensitivity have an impact on the pace of interest rate hikes. Norway and Sweden stand out with their high proportion of variable-rate loans and a large decline in home prices, which means that their interest rate hikes are not expected to keep pace with the ECB. Norges Bank is signalling a final key rate hike in March, depending on data. We believe that due to clearer signs of a slowdown in Norway's mainland economy and an upcoming peak in core inflation, the key rate will stay at today's level of 2.75 per cent. Falling resource utilisation and high interest rate sensitivity among households will then pave the way for rate cuts in 2024.

SEB forecast: We are approaching peak key rates



Source: Macrobond, SEB

We are sticking to our forecast that the US Federal Reserve will deliver its final rate hike in February and then gradually begin cutting its key interest rate during late 2023. Other central banks will then follow suit, carrying out their own rate cuts.

A gloomy growth outlook, a weak exchange rate and high inflation are creating a dilemma for Sweden's Riksbank. We believe the bank will deliver a final 50 bp point rate hike to 3.00 per cent in February; slightly above its latest rate path and 25 bps above our November forecast. Once inflation has fallen more clearly during 2024, we expect the Riksbank to cut its key rate by a total of 75 bps to 2.25 per cent by the end of our forecast period. The Riksbank has completely stopped reinvesting maturing bonds, which means that its balance sheet is now shrinking rapidly. We believe the Riksbank will

follow the Bank of England's example and start actively selling government bonds during the second half of 2023, without significantly impacting household mortgage costs, given the short fixed interest periods of these loans.

Evaluating policy frameworks after a crisis

Various crises have often led to a rethinking of economic policy frameworks or their applications. For example, the stagflation era of the 1970s led policymakers to give up their ambitions to fine-tune resource utilisation in the economy. As a result of the crisis that began around 1990, currency pegs and other soft forms of exchange rate collaboration were largely abandoned. This simplified a country's choices: either full-scale currency unions or floating exchange rate regimes – a dilemma that still divides public opinion in Sweden. The global financial crisis that began around 2008 was followed by a massive expansion of regulatory systems aimed at making the financial system more robust.

Lasting changes in the security policy situation

It is interesting to start thinking about what lessons can be learned from the crisis we are currently in. As for the security policy situation, all indications are that we are entering a new era, although there are still different scenarios for how the Ukraine war will evolve. The belief that mutual trade dependence would bring Russia closer to the EU has been shattered. Among other things, this is likely to change Western Europe's energy supply situation for the foreseeable future. Hopes that increased exchange would promote a rapprochement between China's political system and the West were abandoned by the US during Donald Trump's presidency. There are also various general challenges to global free trade, potentially escalating tensions even between allies such as the US and the EU.

Nevertheless, policy frameworks have been useful

As for our conclusions about stabilisation policy frameworks, a lot will depend on how 2023 unfolds. Over the past year, there has naturally been strong criticism of central banks for their exceptional policy reversal: from years of playing down inflation risks and fuelling higher asset prices to implementing historically very aggressive key interest rate hikes. If our main scenario – a mild recession and a return of inflation close to central bank targets during our forecast period – proves correct, it can still be argued that the existing policy framework has weathered a tough challenge relatively well. It is hard to deny that the established inflation targets have, in fact, helped to prevent long-term inflation expectations from soaring – an important difference compared to the 1970s.

Questionable strategy shift at the wrong time

This does not detract from the great need to carefully evaluate different aspects of how policy frameworks have been applied. The period before the recent inflation surge was marked by an overreliance on strong disinflationary forces. In retrospect, the Fed's change of strategy in 2020 – when it shifted from a more pragmatic view of the relationship between resource utilisation and inflation (the Phillips curve) to an experiment in which it tested the limits of how far it could actually push down unemployment – was badly timed. Partly because of central bank signals to governments that they could expect low interest rates for a long time, fiscal policy in many countries became overly expansionary in 2021. Such bodies as the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) acted in the same spirit. It should be a lesson for the future that recommendations should not be based on the assumption that existing exceptional circumstances will be permanent.

Weak forecasting skills lead to pro-cyclical policies

The difficulty of forecasting actual inflation trends has also been revealed in a rather brutal way over the past year. One consequence of this lack of forecasting skills is that monetary policy tends to be pro-cyclical, i.e., it reinforces cyclical fluctuations. When inflation was low, it was expected to remain so forever. Now that it has climbed, central banks have gradually shifted to the more pessimistic camp regarding inflation. One conclusion we can probably draw from this is that central banks should be pragmatic and always keep an eye on resource utilisation in the economy. Even central banks that have a narrowly defined inflation target – and that lack any formal mandate to ensure high and stable resource utilisation – have the potential to do so in practice. Quite naturally, the potential benefits of stimulus measures in a situation of high resource utilisation are quite small, compared to the risks that things will go wrong.

Room to ease negative side effects

The general question of how much volatility in different variables is acceptable in order to fine-tune inflation to targets also needs to be raised. During the pandemic, for example, home prices were driven up sharply. In small countries with floating exchange rates, large currency movements create various kinds of problems. There should be room to take greater account of such downsides even in the current system, and to avoid rigid adherence to the ends and means of inflation targeting. During earlier periods, for example, central banks have experimented with tolerance or target ranges for inflation and relied more on "leaning against the wind" by keeping an eye on the risks of borrowing and home price bubbles. Although there were sensible reasons for moving away from such a policy, recent experience suggests that it may again be worth weighing its advantages and disadvantages.

Not only the fault of central banks

However, it is not only the fault of central banks that they have gradually drifted towards a more literal application of inflation targeting. EU and national regulations have tended to move in the same direction. A reasonable basic concept here is that the more limited their area of responsibility, the easier it is for central banks to maintain their independence. At one time, Swedish labour unions and employer organisations were also strongly critical of the Riksbank's failure to bring inflation up to its target. Fairly moderate deviations were viewed as a threat to the role of the inflation target as an anchor in wage formation.

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