Investment Outlook

Investors look past soft landing

February 2024

SEB

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Introduction

2023 was a very strong year in capital markets, with sharp increases in value for both equities and bonds. This happened despite continued tightening of monetary policies (higher key interest rates), accelerating geopolitical crises, a lack of corporate earnings growth, a shaky Chinese economy and a dramatic period including several bank failures. Among the positive forces was a global economy that refused to fall into recession despite sharply negative yield curves – usually an infallible signal of an impending slump. In particular, the US economy surprised on the upside. Inflation also kept falling. Late in the year, there was finally a signal from the US Federal Reserve that tight monetary policy had conquered inflation and that the federal funds rate will be cut in 2024. This resulted in a stock market rally during the final quarter of 2023. Other positive stock market forces were artificial intelligence (AI) and GLP-1 medications. These are structurally positive forces that benefited large technology companies, much of the semiconductor sector and the pharmaceutical industry, among others. We discussed these forces in *Investment Outlook* during 2023, both in our stock market texts and in separate theme articles.

Our main thesis for 2024 is that positive drivers will continue to dominate the risk picture. This is why we continue to recommend that our customers stay on the positive side, i.e. between neutral and overweight in risk assets. In this issue we present a more detailed view of appropriate strategic and tactical portfolio composition. It is based on the hope that gradually lower interest rates – combined with a bottoming out of the economy around mid-year – will lead to broader participation in capital markets. This means that several laggards of recent years will have improved opportunities to regain some of the ground they lost to the winners, which have mainly been large tech companies in the US. Together with bond yields that are expected to fall from appetising levels, this should enable both low- and high-risk portfolios to generate good returns. We expect positive returns for both equities and fixed income investments. Risks include potential overconfidence in growth and inflation trends, as well as an even tougher geopolitical environment.

No *Investment Outlook* is complete without thought-provoking theme articles. In this issue, we analyse the status of the Chinese economy, which has undeniably been sputtering in recent years. This has negatively impacted its stock markets. We also follow up on this theme in our global equities section. In another article, we return to the theme of why it is necessary to increase the circularity of our economic system. We examine this issue from several angles and present examples of companies to watch. It is important that we move towards a system with less of a throw-away mentality and a higher degree of efficient reuse.

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

Market view, risk exposure and allocation

We expect a continued soft landing in the global economy. Central banks will respond to falling inflation with key rate cuts during 2024. Economic activity will bottom out during the first half, and consumers will see gradual improvements in their finances as labour markets remain robust while inflationary and interest rate pressures ease. Corporate earnings will rebound in the course of 2024 and early 2025. Risks include the soft-landing consensus itself, a highly uncertain geopolitical situation and a resurgence of fears that inflation will accelerate again. Our view is that the balance is favourable. Our portfolios are overweight in risk assets, although our pure equity overweight is modest. If the soft-landing scenario materialises, this increases the likelihood that the stock market laggards of recent years can regain lost ground, in which case we will partly reallocate our portfolios.

Risk exposure and allocation

As we entered 2023, the investor community was still defensive in its view of the future and in its risk exposure. This was natural, since 2022 was a weak year in capital markets, with both equity and bond investments losing value. The Swedish stock market fell by 20 per cent, global equities fell by 6 per cent – with significant US dollar strength diminishing the decline measured in Swedish kronor – and a weighted fixed income investment index fell by 8 per cent.

In our discretionary portfolios, the stabiliser was our cautiously oriented sub-portfolio of alternative investments, which managed to stay at around zero. What does all this have to do with 2023? Well, it clearly shows how capital markets try to discount the future. Quite a few of the structural headwinds of 2023 had already been discounted in 2022. In the end, 2023 was a very strong year for the above portfolios despite threats of recession, continued interest rate hikes, exposed credit risks, geopolitical turmoil, falling corporate earnings and more. With the benefit of hindsight, some things turned out better than feared and others ended up clearly worse than expected.

Looking at the positive side, the US economy and labour market held up better than expected. In addition, the financial system coped reasonably well with interest rate stress. Corporate margins remained at good levels. Other important positive factors were the way central banks and governments handled last spring's acute banking sector problems – sparing us from moving towards a financial crisis – and last but not least, the continued decline in inflation rates from high levels.

At the company-specific level, structural forces contributed positive energy. These included companies linked to artificial intelligence and GLP-1 medications. GLP-1 was originally used for treating diabetes, but it has proved effective in treating a number of other conditions, such as obesity (see the theme article in November's *Investment Outlook*). On the negative side, we saw further geopolitical turmoil, including a Middle East conflict, anaemic Chinese economic growth and powerful monetary tightening by central banks, which drove up interest rates. This led, in turn, to last spring's bank collapses and severe stress in the Swedish real estate industry.

Our strategy since September 2022 has been to avoid being too defensively positioned and to ensure that our portfolios have good risk diversification. We have also tried to benefit from positive structural forces. This allowed us to capture the healthy returns generated by both fixed income and equity investments. The journey was bumpy and the pitfalls many, but the end result was strong. Crucial to this outcome was our view that inflation had already peaked in mid/late 2022, and that there were thus good reasons to assume that investors' risk aversion peaked at the same time. This strategy was challenged when banking sector problems in the US and Switzerland escalated during the first half of 2023. At that time, we would have been forced to reduce our risk if central banks and governments had not acted as resolutely as they did.

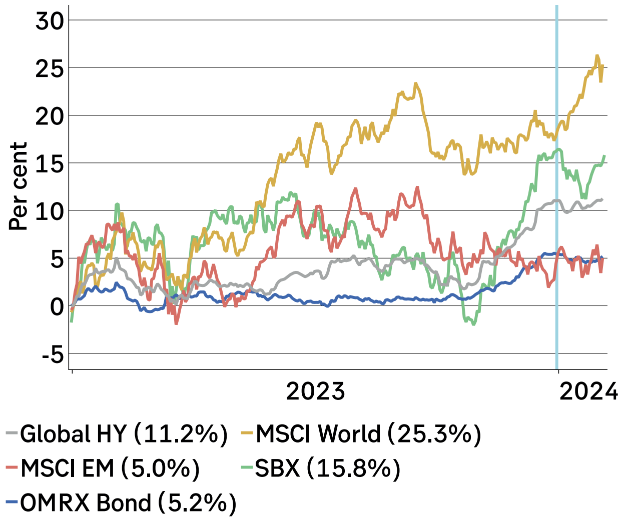
> *"The journey was bumpy and the pitfalls many, but the end result was strong."*

The real shift in capital markets only occurred when the US Federal Reserve changed its message from "higher rates for a long time" to "we are done hiking rates and will start planning for cuts in 2024". This happened around the end of Q3 2023 and once again showed how important central banks are to risk appetite in a world where aggregate debt is substantial.

In the end, large global (American) growth companies in the technology sector turned in the best performance, benefiting from strong balance sheets, clearly better earnings than many other sectors and a gradual appreciation in share prices that was strongly linked to AI. Among the losers was the Chinese stock market.

The Swedish stock market fluctuated sharply during 2023, but with a very strong final spurt it managed to overtake the global stock market – including emerging markets – measured in SEK, even though the global market includes the major tech companies. Both the Swedish stock market and the global stock market, expressed in Swedish kronor, ended up with a positive return of just over 18 per cent. A balanced fixed income index also delivered a strong return of around 5-6 per cent.

Swedish equities caught up with global equities during the final quarter of 2023



Source: Bloomberg

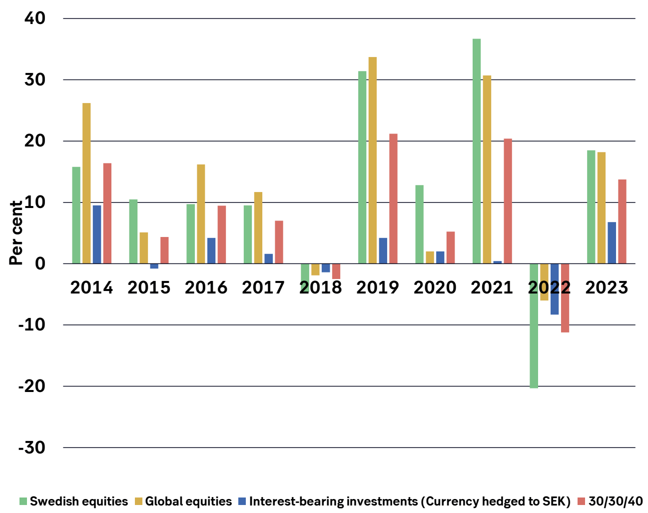
The chart shows the performance during 2023 and early 2024 of an index of listed Swedish equities (SBX), the MSCI World Index and the MSCI Emerging Markets index, in terms of SEK. The Stockholm stock exchange slightly surpassed the sum of the world and EM equity indices last year. Also shown are a Swedish fixed income index (OMRX Bond) and a global high yield (HY) index, hedged to SEK. The vertical line indicates the beginning of 2024.

Despite warnings, a balanced portfolio has worked well and continues to have good prospects

The chart below shows the performance of a classic balanced portfolio, often called a 60/40 portfolio. This refers to 60 per cent equities and 40 per cent fixed income investments, a common allocation among investors in Sweden and internationally. During the long period of extremely low and in some cases negative government bond yields, this portfolio structure was challenged. Critics argued that it was outdated and obsolete because the idea of risk diversification no longer worked. The basic idea has always been that the fixed income component is the stabilising part of the portfolio if stock markets fall. When interest rates turned negative, this function ceased to apply. In addition, government bonds were largely replaced by corporate bonds, which in themselves have a higher covariance with equities, thereby undermining risk diversification. We tried to balance this by adding alternative investments with other characteristics and overweighting global equities in relation to Swedish ones to boost our exposure to the US dollar, which possesses defensive qualities in a balanced portfolio. On top of this, many investors added illiquid exposures with bond-like characteristics.

Critics of 60/40 portfolios argued that these portfolios would collapse on the day that central banks normalised key interest rates and abandoned their supportive purchases of fixed income investments (quantitative easing, QE). We have moved past this period, and it certainly hurt these portfolios during 2022, as shown in the chart below. But if we extend our perspective a little, we see that these concerns were exaggerated and that over time, the portfolios worked as intended. Now that we have reached the end of the rate hiking cycle, the previous order has been restored. It is once again possible to build portfolios with different levels of risk that have reasonable return potential, ranging from 100 per cent fixed-income investments up to 100 per cent equity exposure. The factor behind this change is that we now once again have reasonable interest rates in the financial system. In recent years, illiquid assets that were previously reserved for large institutions have also become available to private individuals, and investors thus have access to good alternatives with other characteristics.

The performance of a balanced portfolio, measured in index terms, over the past 10 years



Source: SEB

The chart shows the year-on-year performance of Swedish equities, global equities and a fixed income portfolio that mixes government bonds and corporate bonds. The return figures are based on the index performance of each asset class. These return figures have then been used to create a sample portfolio consisting of 30 per cent Swedish equities, 30 per cent global equities and 40 per cent fixed income investments. All figures are presented in SEK.

Now is the time to look ahead. What can we expect? What will happen during 2024 and beyond? Let us start with our macroeconomic view.

Take a seat – it's time for a soft landing

After a few turbulent years, the world economy appears increasingly stable. Surprisingly robust household demand, together with inflation that is rapidly falling towards central bank targets, will result in a mild deceleration with lower interest rates, a better investment climate, lower costs for companies and more positive conditions for household finances during 2024. There are still many question marks – geopolitical turbulence, high indebtedness and the risk of a further slowdown from recently increased costs may worsen the situation. But because of falling inflation and interest rates, together with the prospects for higher demand during the year, we expect our hoped-for soft landing in the US economy to materialise. In Europe, including Sweden, growth has been weaker. The figures have recently been negative. However, we expect an improvement in these countries as well. The Chinese economy is continuing to perform sluggishly, yet the overall emerging market sphere will help the global economy keep growing by around 3 per cent both this year and in 2025.

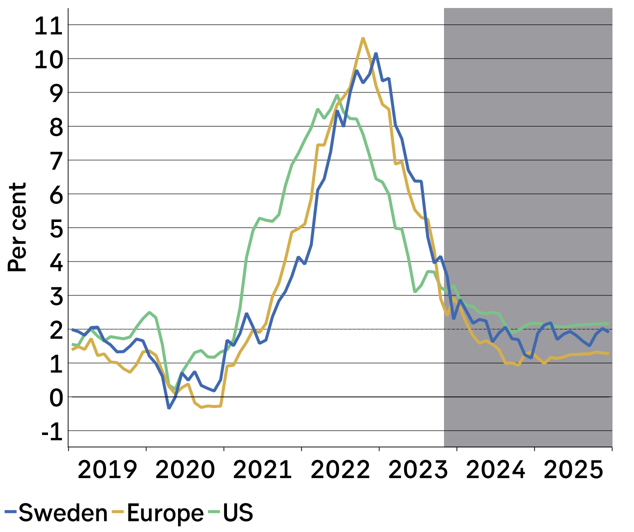
Falling inflation, which we expect to reach targets during 2024, has already had an impact on long-term bond yields. We expect central banks to begin an interest rate cutting phase this spring. Our forecast includes more rate cuts in the US than in Europe, since the Fed's starting point is higher – from 5.5 per cent to 4 per cent – while the European Central Bank and Sweden's Riksbank will go from 4 to 3 per cent this year. Key rate cuts will continue in 2025, ending up at 3 per cent in the US, 2 per cent in the euro area and 2.25 per cent in Sweden, according to our forecast. Important statistics on the probability of the soft-landing scenario were presented recently; America's fourth quarter GDP growth rate came in at 3.3 per cent, and underlying consumer price inflation declined from 2.6 per cent in the previous quarter to 1.7 per cent during the final three months of 2023.

GDP growth forecasts, %

Market	2023	Rev	2024	Rev	2025	Rev
World	3.1	0.1	2.9	0.1	3.1	-0.1
United States	2.4	0.1	1.6	0.5	1.8	-0.0
China	5.2	0.0	4.6	0.0	4.4	-0.1
Germany	-0.3	-0.1	0.0	-0.5	1.6	-0.4
United Kingdom	0.5	0.1	0.2	-0.3	1.4	-0.3
Sweden	-0.4	0.6	0.1	0.5	2.8	0.3
OECD	1.6	0.0	1.4	0.2	2.0	0.0
Euro area	0.5	0.0	0.5	-0.2	1.8	-0.2
Baltics	-1.0	-0.3	1.2	-0.3	2.9	0.0
Emerging markets	4.3	0.2	4.1	0.1	4.0	-0.1

The table shows forecasts and revisions (Rev) for real year-on-year economic growth in per cent, in line with our main scenario and 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 23, 2024.

Our forecasts indicate that inflation is moving towards central bank targets



Source: SEB Nordic Outlook

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

The probability of conceivable outcomes and a more detailed picture of economic developments are presented in the "International overview" section, which is an excerpt from the *Nordic Outlook* published on January 23.

Has the market already discounted the full potential for improvement?

Despite the strong performance of stock markets during 2023, the average professional investor continues to hold a significantly higher proportion of bonds than usual. In a long-term perspective, the normal situation is that the proportion of bonds is lower than in benchmark indices. This underweight is used to fund a long-term overweight in equities, which over time is intended to provide extra returns for a portfolio compared to its benchmark indices.

Monitoring what other investors are doing is what we usually describe as the positioning or risk appetite factor. Our point is that if the investor community has a very positive attitude, and thus holds a high proportion of equities, potential is usually limited in the sense that the need to increase risk – for example, through further purchases of equities – does not exist. The opposite is true if the same investor community is very risk-averse and defensively positioned.

During the COVID-19 pandemic, both governments and central banks took steps to prop up the global economy. This had a strong impact on capital markets, which recovered very quickly. These measures stimulated risk appetite among investors, which in turn drove up valuations of financial assets. The same stimulus measures also fuelled the powerful surge of inflation that later forced central banks to implement massive monetary policy tightening. This, in turn, reversed risk appetite and lowered prices in both the stock and bond markets. The above-described process continued until September 2022. At that time, risk appetite was very low. Investors had moved their money into cash, low-risk bonds and sectors of the stock market that have historically exhibited defensive characteristics. Since then, risk appetite has gradually increased, but we are not yet back to the "normal" level of long-term risk-taking, expressed as the proportion of equities relative to bonds in a portfolio. A not-so-advanced guess is that most investors are hoping for good returns on their bond positions during the first half of 2024, and as interest rates hopefully fall, some of this exposure will be shifted towards equities. These shares will then be supported by a gradually improving economy that will continue into 2025 and create earnings potential that will thus support equity investments in general. These are among the reasons for our relatively positive view of the stock market.

The strong spurt during Q4 2023 and the robust start to 2024 will partly erode potential returns going forward. However, there is good reason for a positive view of capital markets, connected to our soft-landing forecast. If things turn out more or less as expected, this should result in declining government bond yields. Yields on shorter maturities will change more than those on longer maturities, since the former are more closely connected to central bank policy rates and the latter have already fallen to relatively low levels, especially in Europe including Sweden. The end result would then be lower government bond yields and yield curves with a positive slope, i.e. short-term yields would be lower than long-term yields. A portfolio of government bonds should then deliver a positive return along the way, because of both a good yield level and the price increase as yields fall. Corporate bonds generated very strong returns in 2023. One clear contributing factor was that interest rate spreads fell; they are now at low levels. However, high yield segments in Europe and the US showed attractive current yields, in the range of 7.5-8 per cent.

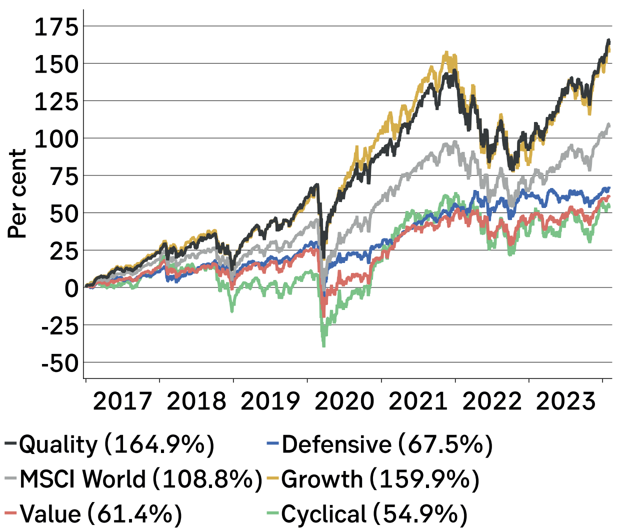
"Risk appetite has gradually increased, but we are not yet back to the 'normal' level."

In equity markets, the valuation parameter looks like the charts below. Valuations have definitely increased, measured as price-earnings (P/E) ratios. Valuations of different types of companies have also drifted apart. A company's potential for generating better earnings is strongly connected to its level of activity or to the economy. Leading indicators such as purchasing managers' indices (PMIs) – surveys in which companies are asked to state their current situation and future prospects – indicate that the trend is likely to stabilise eventually. Combined with a hoped-for gradual decline in interest rates, this strengthens the potential for upward revisions of corporate earnings, although we must first make it through a couple of quarters with a lower level of activity.

So far, this has benefited large tech companies and firms that dominate their market at the sectoral level – for example in luxury goods and pharmaceuticals. As the economy stabilises, if interest rates come down and China follows through on its stimulus plans, investors may well reallocate their portfolios towards broader equity exposure. This should benefit smaller companies and emerging markets, among others, so that some of the valuation gaps are reduced. However, the burden of proof is on these stragglers, since we have had a long and stable trend in which the winners have included companies with solid and rapid growth, as well as high-quality companies. This "quality" designation refers to their ability to generate earnings (stable or rising margins) and strong balance sheets (strong positive cash flow and a high ratio of equity to debt). The charts below show that these winners have also lifted the market via progressively higher valuations compared to other equities. Many such companies are based in the US, and they are an important reason behind the stock market's strong performance. The P/E ratios for the MSCI World Index and the MSCI Emerging Markets Index are nevertheless quite close to the averages that prevailed for the period before the pandemic, which temporarily drove up the entire stock market's valuation.

To summarise the above: investors' risk appetite has risen since September 2022 but has not yet reached its long-term normal situation. Valuations of both corporate bonds and equities rose in 2023. Inflation, and thus central banks, must behave as expected in order not to challenge interest rate spreads and P/E ratios. Portions of the stock market definitely have the potential to enjoy higher valuations. In those portions that have clear premium valuations, companies must continue to deliver strong earnings in order to maintain these premiums.

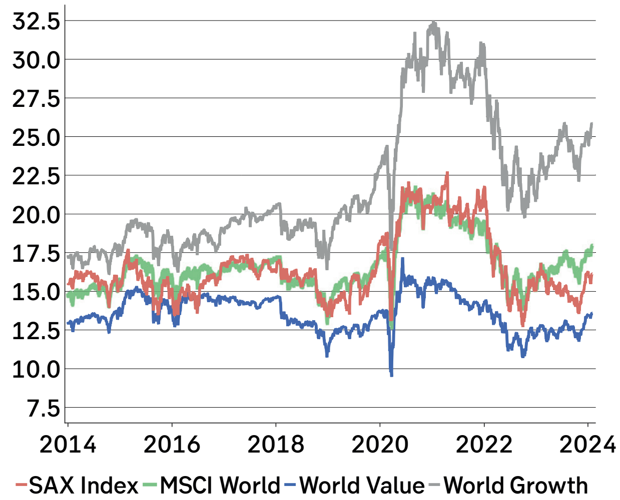
Large growth companies maintain high quality and have driven returns in a world index



Source: Macrobond, MSCI

Large, highly profitable growth companies are the long-term winners in a world index. The majority of these are located in the United States.

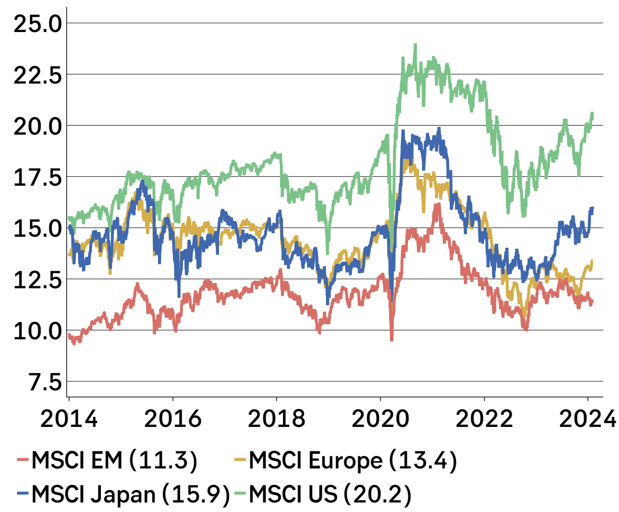
Growth companies' achievements have resulted in premium valuations



Source: Macrobond, MSCI

The global winners have gradually received higher valuations expressed as price-earnings (P/E) ratios. In 2022, parts of this premium were reduced, but the gap in relation to average valuations is higher than before the pandemic. Both a Swedish stock index (SAX) and a global index (MSCI World) show P/E ratios today in the same range as before the pandemic.

These growth and quality companies are mainly located in the US, as reflected in the country's premium valuations



Source: Macrobond, MSCI

The global winners have gradually received higher valuations, expressed as P/E ratios. The majority of these are American companies. This explains why the US market has become more expensive, measured in P/E ratios, while the rest of the world is more or less at "old" levels.

There are certainly risks, despite the increased likelihood of a soft landing

The fact that the market has become increasingly positive and is discounting a fairly comfortable soft-landing scenario is obviously a risk in itself, if the actual outcome turns out to be worse than this. Historically, a period of negative US yield curves has always resulted in a recession. The period ahead could thus be the exception that proves the rule. The labour market has not cooled down, and consumers have pandemic stimulus money and pent-up consumption needs, which have clearly affected them in a positive direction. The risk is that the old correlations – where a negative yield curve and rising short-term interest rates lead to a clear economic downturn – will apply but the time lag will only be a bit longer than usual.

Another potential setback would be a disruption of the downward inflation trend – leading to a period when inflation will stagnate or rise again. Geopolitical turmoil and the stable labour market might perhaps lead to this type of setback, which in turn would delay central banks' interest rate cutting plans. This would be a sensitive mechanism, since investors are hoping and expecting large key rate cuts in 2024.

Finally, the geopolitical situation seems to be deteriorating. Russia is still waging war in Ukraine. China is continuously expressing its displeasure with Taiwan. In the Middle East, the situation around Israel remains chaotic, and in the rest of the region, attacks are taking place between countries and against shipping that passes through nearby waterways. This has driven up the cost of shipping. If the situation deteriorates further, oil and gas prices could rise.

Our portfolio composition delivered for us in 2023, and we will maintain it in early 2024

The structure of our portfolios is such that they perform well amid rising risk appetite, and they decline when risk aversion increases. This means we are overweight in risk, although the equity portion of our overall portfolio is only marginally overweight. In our global sub-portfolio, we maintain an overweight in last year's winners, US large growth companies. This is complemented by an overweight in small and medium-sized enterprises, with a focus on lower valued companies. There are clear underweights in Europe and some defensive sectors. If our main scenario holds, it is likely that we will gradually adjust this portfolio composition during the year.

In Swedish equities, our focus is on equity-specific risk-taking among major listed companies, supplemented by what we regard as a suitable proportion of small and medium-sized companies that we invest in via small cap funds. The latter experienced a weak period throughout 2022 and in 2023, apart from the rally during the last quarter. This weak period resulted in a much-needed downward adjustment of the valuation parameter, and the future outlook is improving.
In fixed income investments, we do not expect a continued narrowing in credit spreads or sharp declines in long-term yields. On the other hand, we do not expect any drama in the other direction either. We are thus starting 2024 with neutral exposure to high yield corporate bonds and an overweight in investment grade bonds, and with an average duration of just over three years.

Because of higher interest rates in the financial system, this composition in our portfolios results in higher overall expected returns compared to the zero-interest rate period, despite the fact that we had a double weighting in high yield bonds at that time. Finally, our portfolio of alternative investments is dominated by holdings in so-called macro hedge funds, followed by holdings in market-neutral equity hedge funds. This composition still acts as a shock absorber in our portfolio.

Global equities

Economic recovery and normalised valuations

Last year closed on a cheerful note, with world equity indices up 14 per cent in local currencies between late October and December 31. Stock markets were fuelled by falling inflation and a more dovish message from the Fed, resulting in steeply falling long-term yields in the US and Europe. Until November, the stock market upturn was dominated by a few large US-based tech companies, but then the rally broadened. The most depressed segments, such as small caps, rebounded the most strongly. But along with risk appetite the SEK appreciated, especially against the USD, dampening returns for Swedish investors with open currency positions.

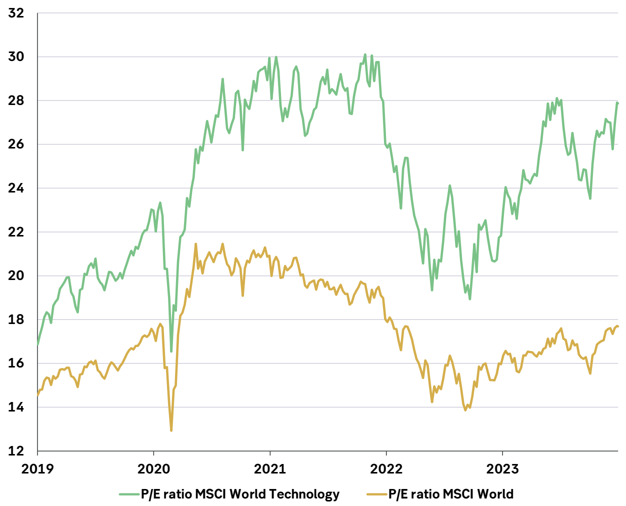
During 2023, most stock markets showed clear gains. Especially prominent in this upturn was America's tech-heavy Nasdaq Composite index, buoyed by its seven biggest companies, popularly known as the "Magnificent Seven". Towards the end of the year, European stock markets and the broad US market rose in line with Nasdaq, while Chinese exchanges did not keep up with the rally at all, thus adding another negative stock market year to their record. Growth companies outclassed value companies during the year, and the tech sector was by far the best performer.

We have been optimistic about US growth and tech companies for a long time, but the question that we and many other investors are asking is whether the fantastic share price performance of this sector can continue. Has growth reached a saturation point? Can these valuations be defended? We believe that the growth of the tech sector as a whole is structural for both producers and consumers and appears unlikely to slow down soon. Quite the contrary.

Valuations, on the other hand, are trickier because they are historically high while at the same time we must factor in and calculate the degree of growth and margin trends for many years to come. But we believe that tech sector valuations should not fall in the near future, since the rate of earnings growth seems to be improving, especially compared to other sectors. The air is starting to get thinner at current valuation levels, though. When growth slows, valuations are likely to fall, but we are not there yet.

A completely different market segment that we find attractive – but largely for other reasons – is small caps that have underperformed large caps. This is especially evident over the past two years, which is mainly due to the upturn in interest rates, since these smaller companies are more highly leveraged on an aggregate basis. On the other hand, small caps will benefit from the economic scenario we are forecasting, namely an economic soft landing and interest rate cuts. Their valuations are historically low, especially relative to the broader index. We also expect faster earnings growth for smaller companies.

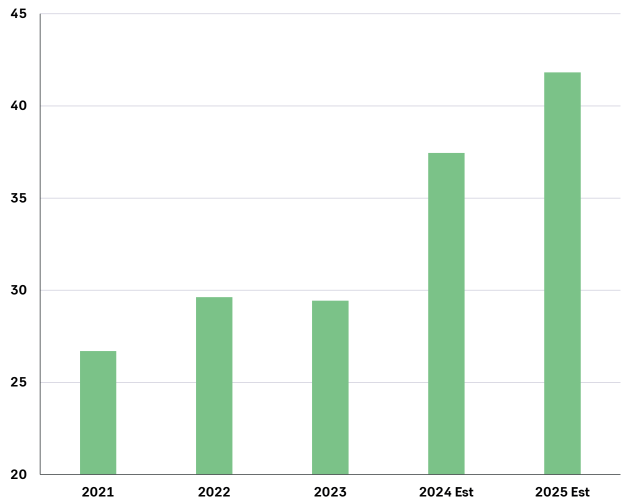
Tech sector valuations are again significantly higher than the rest of the market



Source: Bloomberg

The graph shows the changes in the price-earnings ratio for the technology sector and for a global equity index over the past five years.

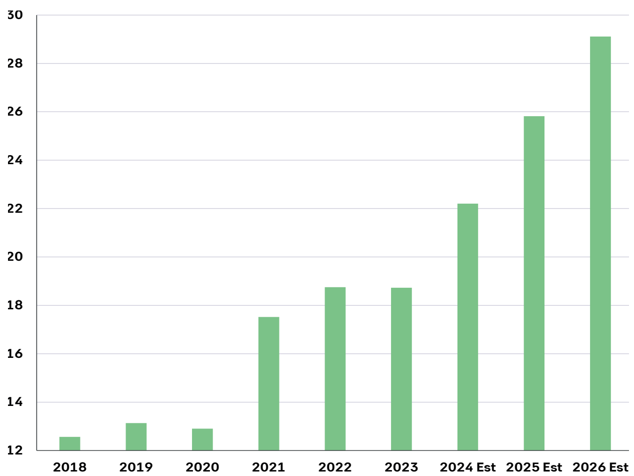
We expect small-cap earnings to grow rapidly during the next two years



Source: Bloomberg

The table shows historical and projected gains for the MSCI World Small Cap Index.

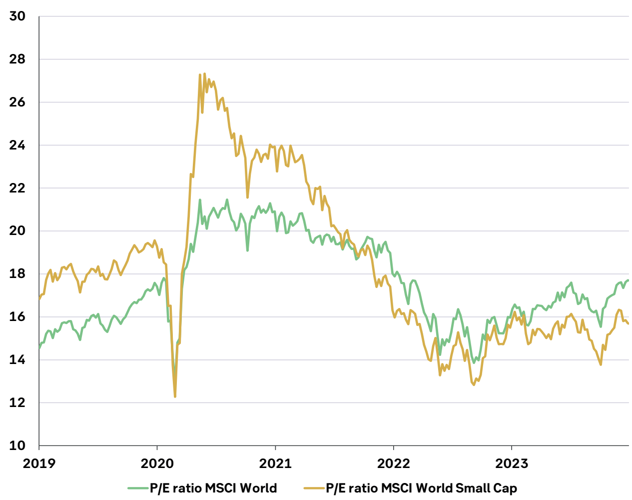
After a few years of consolidation, we expect strong earnings growth in the tech sector



Source: Bloomberg

The table shows historical and projected earnings of companies in the MSCI World Information Technology Index.

Small caps are also undervalued



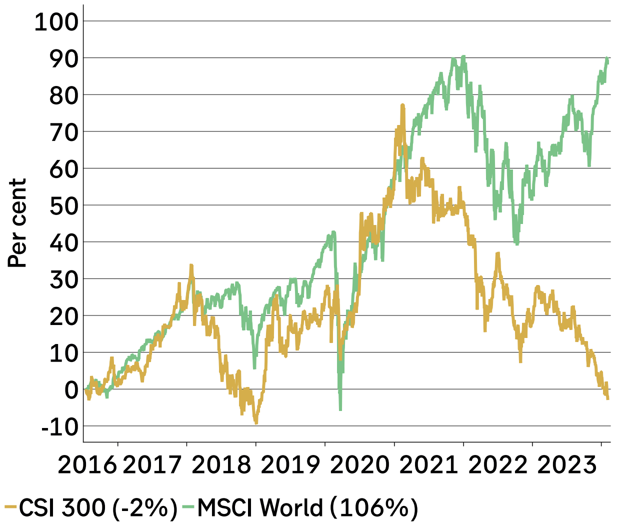
Source: Bloomberg

The chart shows the changes in P/E ratios for the MSCI World Small Cap index and the MSCI World index over the past five years.

Is it time to look more closely at Chinese equities?

This issue of *Investment Outlook* includes a theme article focusing on Chinese politics and macroeconomics, since China remains one of the most important countries for our global economy. However, Chinese stock markets account for a tiny share of world equity indices, just over 3 per cent, which makes it easier for global asset managers to label Chinese equities as "non-investable", considering the government's erratic regulation of the business sector. China's close links to Russia and aggressive stance on Taiwan do not make things any better. The country's stock market performance has been almost catastrophic over the past three years – in common currencies, the MSCI China index, which is large cap and technology-dominated, has fallen by 57 per cent. The CSI 300, which represents the Shanghai and Shenzhen stock exchanges, is down 44 per cent, while the world index rose by 16 per cent during the same period.

Plunging Chinese stock markets



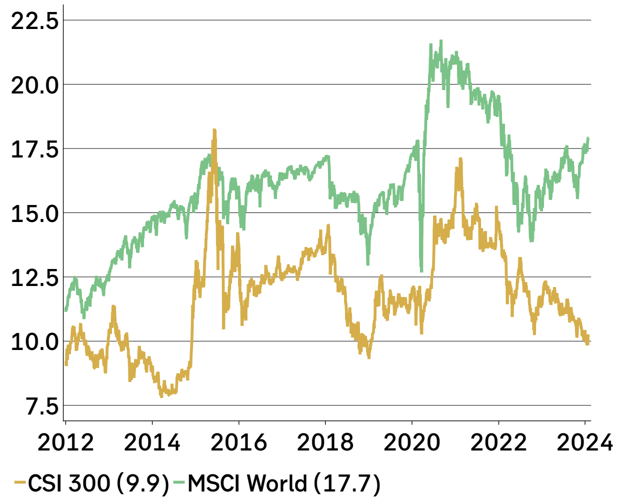
Source: Macrobond

The chart shows the MSCI World index (excluding emerging markets) compared to the CSI 300 index, which represents the largest companies on the Shanghai and Shenzhen stock exchanges.

So is it time to take a closer look at Chinese stocks? From a valuation perspective, the answer is undoubtedly yes, since valuations are at extremely low levels. China also has a dynamic business sector with a high degree of innovation. The emergence of large innovative companies over the past 20 years is impressive, including internet giants such as Tencent, Baidu, JD.com, Meituan and Alibaba. In recent years, new giants have emerged, for example Pinduoduo (e-commerce) and Bytedance (TikTok).

However, there are major structural problems in China – increasingly dogmatic communist rule with all this entails in the form of state interference in business and political confrontations with other countries. In addition, the country has experienced 30 years of strong expansion with very high leverage, especially in the real estate sector, which will take many years to remedy. Chinese growth and profits have been weaker than expected since the end of COVID-19 lockdowns, and there are concerns about how well China will succeed in its transition to a more modern society.

Chinese equity valuations are historically low compared to a world index



Source: Macrobond

The discrepancy between price-earnings ratios in the MSCI World index and on Chinese stock exchanges has widened recently.

However, the stock market has more than discounted the gloomy economic outlook, limiting its downside. But when will it normalise? When valuations collapse as they have done in China, it doesn't take much to reverse the stock market trend. Foreign ownership is at a record low, and China is now being underweighted by emerging market investment managers – a trend that may quickly reverse at the slightest improvement. China has something called "The National Team", which is an investment fund that is in the habit of buying Chinese stocks when things look darkest. There is speculation that it is time for sizeable supportive purchases, which may well reverse the trend. If earnings forecasts are correct, by itself this will be enough to lift Chinese equities. Earnings have fallen for two years in a row but are expected to grow by more than 20 per cent this year compared to 2023 and also surpass 2021 earnings. In any case, the balance between these negative forces and potential triggers, as well as low valuations, is better than it has been for a long time. But it remains to be seen whether this will lead to a change or not.

Conclusion

A harsh macroeconomic climate, with weak growth and high inflation, has been replaced by hopes of improved economic activity and lower interest rates. We regard 2024 as a year of normalisation – depressed sectors and market segments are recovering. The United States will not completely dominate these improvements but will instead be joined by Europe and Japan and eventually also emerging markets, which have been left behind for a few years. Of course, China is still the key to the performance of Asian and to some extent Latin American stock markets, but we expect decent growth in China and a degree of flirtation with financial market actors. At present, however, we prefer the tech sector as well as small caps on a global basis – IT companies for their high rate of earnings growth and structural growth, and small caps for their upside potential in an approaching positive macro environment.

Nordic equities

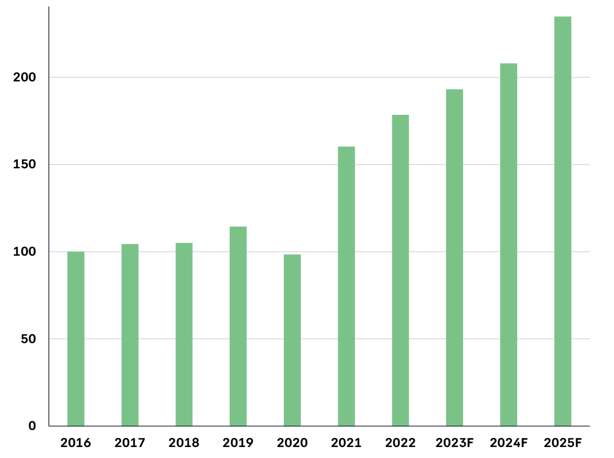
What can go wrong?

The stock market got off to a good start in 2023 and closed the year with an extremely positive performance, but it was relatively volatile in between. Sweden’s large cap index was at the same level in late October as at the start of the year, while its small cap index fell nearly 10 per cent. Over the past three months, both Nordic and Swedish stock market indices have climbed 13 per cent, while US equities have posted an even stronger performance and Swedish small caps have surged more than 20 per cent. Driving this upturn are expectations of sharply lower interest rates in 2024, while earnings are expected to continue to grow. In the US, a nearly perfect “economic soft landing” is anticipated, and while we do not foresee similar growth in Europe or Asia, companies are not expected to face an earnings recession. For Swedish companies, earnings are expected to grow another 8 per cent in 2024 from their 2023 record highs.

If expectations prove correct and interest rates fall sharply this year while earnings continue to grow from record highs, it is perfectly reasonable to expect another good stock market year in 2024. Interest rate cuts during 2024 should have a positive impact on the economy towards the end of the year and/or in 2025, which should improve earnings growth further.

Perhaps the best of worlds awaits the stock market. However, we see a number of significant risks that may change the situation. The economic slowdown had a greater impact on earnings in late 2023 than analysts anticipated, and earnings forecasts have been revised downwards both before and after quarterly reports. Although bond yields have fallen from their October 2023 peak, they remain high from a short-term historical perspective. Above all, high real interest rates could affect many segments of the economy going forward, not just residential construction and commercial real estate.

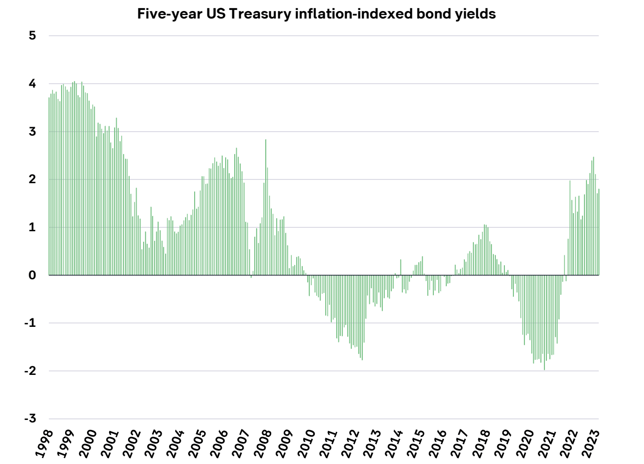
Indexed net earnings for companies listed in Stockholm, with SEB forecasts



Source: SEB

The chart shows indexed earnings growth for companies listed on the Stockholm stock exchange that SEB monitors (including, for example, Swiss-based ABB and UK-based AstraZeneca). The economic slowdown and the dramatic upturn in yields and interest rates in 2022-23 have left no visible traces on aggregate earnings growth for listed companies, nor are they expected to. New record earnings are predicted for 2024, with earnings growth accelerating again in 2025.

US inflation-indexed bond yields down from their peak, but high in a long-term perspective



Source: SEB, Bloomberg

The chart shows the yield on five-year Treasury inflation-indexed bonds. The turnaround is enormous after 15 years of ultra-low interest rates. Indexed bond yields were even higher 23 years ago, but since then there has been a significant change in debt levels for large parts of society. Fixed income investments are once again a clear competitor to equities for investors' money. Meanwhile higher capital costs should put the brakes on investments in real assets, not only residential and commercial properties.

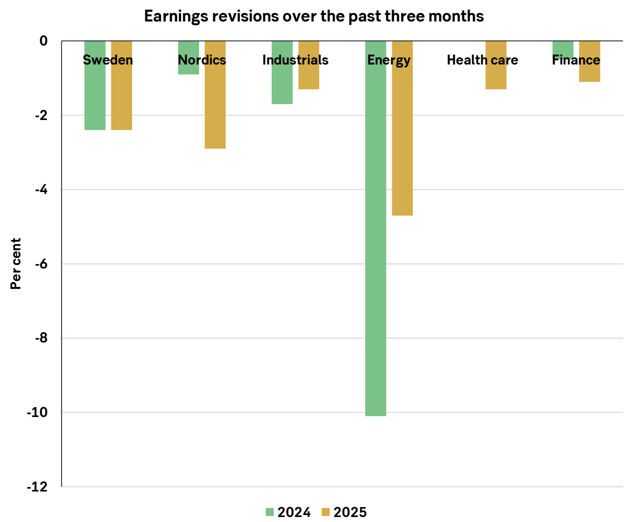
The report period has led to lower earnings forecasts

So far, company reports for Q4 2023 have not been impressive. The share of downside surprises is unusually large. During January, there have been nearly twice as many downward as upward revisions of 2024 and 2025 earnings forecasts.

Among the upward earnings revisions, two industries are clear standouts – real estate companies and transport/shipping companies. Earnings forecasts for real estate companies are benefiting from lower interest expense forecasts. Earnings for shipping companies in 2024 are being revised upward due to attacks on ships in the Red Sea, which have disrupted transport through the Suez Canal. This, in turn, has driven up freight rates and capacity utilisation in maritime transport but has also caused more companies to switch to air cargo.

At an aggregate level, we have lowered our earnings forecasts for Sweden over the past three months by more than 2 per cent for both 2024 and 2025. Looking at the Nordic region, we have lowered forecasts by 1 per cent for 2024 and 3 per cent for 2025. We have revised earnings forecasts downward for most sectors: industrials, energy, finance, consumer goods, commodities and telecommunications. For the transport sector, we have made upward revisions for 2024 related to the Suez Canal situation but downward revisions for 2025.

SEB's revised forecasts over the past three months for selected sectors and geographic regions



Source: SEB

The chart shows aggregate earnings forecast revisions over the past three months for companies in Sweden and the Nordic region that SEB monitors, as well as for some of the largest sectors in the Nordic region: industrials, energy, health care and finance. The three-month period covers all earnings revisions before and after the Q4 reports released as of this writing, which is less than halfway through the report period. Downward revisions clearly dominate, but there are also some upward revisions, including for some of the most profitable companies.

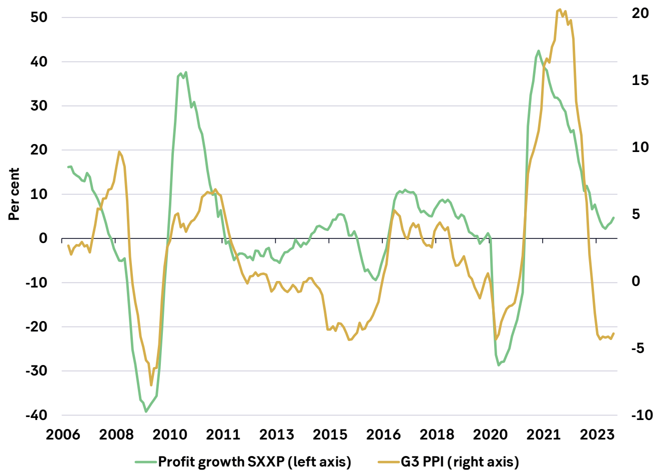
Price pressure is usually negative for corporate earnings growth

When inflation increased in 2021 and 2022, this first became visible in producer price indices (PPIs), which have fallen more sharply than consumer price indices (CPIs). That is true for both the total and adjusted versions of the indices. Producer prices measure the price trend for the goods that manufacturers sell, and there is already deflation in Europe, the US and China. In China, producer prices have fallen at an annualised rate since October 2022. In Europe they have fallen since May 2023, and in the US they have fluctuated since May 2023 between small negative and positive figures. After enormous price hikes in 2022, the fall in prices is partly a normalisation after the earlier upturn, especially for energy, transport and commodities.

However, falling prices are often an indication of a market in imbalance, with supply larger than demand. This is an environment where companies usually do relatively poorly, so it is natural that earnings growth and producer prices have historically tended to fluctuate in tandem. Looking at the Nordics, a few companies have stood out with their impressive performances – currently the Danish pharmaceutical group Novo Nordisk, and previously companies such as Equinor (formerly Statoil) and the Danish shipping company A.P. Møller – Maersk, but historically also the Nordic telecom companies Nokia and Ericsson. In order to see the correlation between earnings and inflation more clearly, we therefore look at a broader index such as the STOXX Europe index of the 600 largest European companies. Of these, 118 are Nordic while others have a Swedish connection – such as the engineering group ABB, the pharmaceutical group AstraZeneca and the photovoltaic equipment maker Tigo.

Historically, periods of negative producer input inflation like the present have been associated with clearly poorer earnings growth for European companies. Although earnings growth expectations have fallen sharply amid lower inflation over the past 18 months, positive earnings growth is still anticipated. Historically, price declines like those we are now seeing have often been associated with shrinking profits for European companies. If the more optimistic earnings outlook this time around reflects underlying structural changes that have improved profitability, such an interpretation will clearly benefit the stock market. A more negative interpretation of the situation is that earnings growth forecasts are too optimistic at present and that the lowered forecasts seen early this year are the beginning of more significant downward revisions.

Falling goods prices slow inflation but have often had an unpleasant downside



Source: Bloomberg

The chart shows producer price inflation (weighted average for China, the US and the EU) relative to expected earnings growth over the coming year for European listed companies. Earnings growth expectations have fallen along with inflation, but not at all as sharply as may have been feared given historical correlations. Are things different this time? We see a risk of downward forecast revisions but also note that if forecasts prove correct, the stock market boom of recent months is well justified.

Are political risks for real this time?

Investors have learned to ignore political risks. It has been an especially poor strategy over the past 20 years to sell stocks as a response to political turmoil – events ranging from the Greek debt crisis to the outbreak of the war in Ukraine have taken place without a significant impact on corporate earnings generation, which is ultimately the key to share performance. However, there are events that have strongly affected earnings, such as the compulsory quarantine measures during the COVID pandemic. In that case, the impact on the stock market was nonetheless ultimately positive thanks to massive stimulus measures, but such events are a reminder that political risks can have a substantial impact. Had they not coincided with the economic stimulus measures implemented at that time, the stock market trend would have been much different.

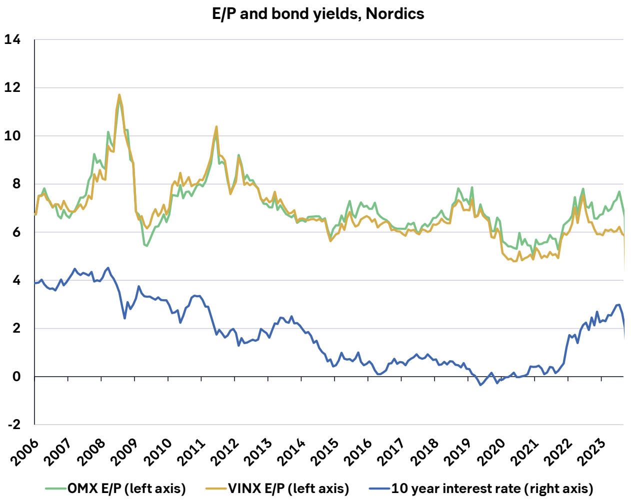
Another factor that has cost companies big money in the modern era is tariffs and trade wars. Sadly, there is a clear risk that trade wars will widen this year or in early 2025. In recent months, the war in Ukraine has essentially fallen off investors' radar, but this too is something that could reappear during the year if US support disappears.

There is unfortunately also a definite risk that US political developments this year could further worsen what are already bad relations with China. The nightmare scenario is a direct military conflict between China and Taiwan/the US, which would also have a very large impact on the economy and the stock market. Even a less dramatic escalation of the conflict could have a negative impact on the earnings outlook.

Given current valuations, it is hard to see investors factoring in any of the many potential political threats that exist. Hopefully, the world will avoid going off the rails, but the political risks appear to be unusually high, while investor preparedness for potential setbacks is low. For companies with a large exposure to the US market and a focus on climate change solutions, the US presidential election in November should be one of the most important issues. It is also worth noting that climate change solutions affect more than such sectors as renewable energy. In most industries, companies now highlight their low-carbon transition as a key driver and competitive factor – this holds for everything from transport to electrification to metals produced with an extra-low carbon footprint.

At SEB's annual Nordic Seminar, held in Copenhagen during January with more than 160 listed Nordic companies in attendance, three quarters of the companies indicated that they are seeing an acceleration in the transition to a net-zero carbon economy.

Valuations on the Stockholm exchange are at a normal level, but the risk premium remains low



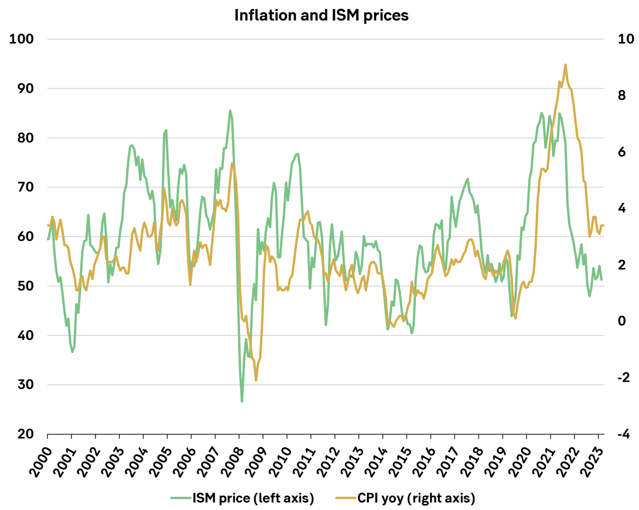
Source: Bloomberg

The chart shows the earnings-price or E/P ratio (an inverted P/E ratio, which expresses earnings as a yield to shareholders) for large caps in Sweden (OMX) and the Nordics (VINX), respectively, compared to 10-year Swedish government bond yields. Historically, investors have normally demanded greater compensation for the higher risk of investing in equities versus government bonds than is the case today. The Stockholm stock market is valued on a par with its average over the past decade, while Nordic listed equities as a whole are more highly valued due to the higher valuation of Novo Nordisk.

Summary and conclusion

The outlook is bright. The earnings trend is much better than may have been feared after the upturn in interest rates in recent years and the dramatic decline in inflation for industrial input goods over the past 18 months. Meanwhile interest rates are now expected to fall significantly in 2024, which should further bolster earnings next year as well as valuations right now. At the same time, stocks are already generously priced, which provides limited scope for tolerating any downside surprises. The report period for the fourth quarter of 2023 has got off to a weak start, with downward forecast revisions as a result. We also see substantial political risks in 2024 – risks that may have an actual and significant impact on company earnings and thus a more sustained impact on the stock market than various events over the past 15 years, which have only caused temporary hiccups.

Inflation has fallen quickly but has still not reached central bank targets



Source: SEB, Bloomberg

The chart shows US inflation, as measured by the consumer price index (CPI), and average price components in the US manufacturing and service sectors, as measured by the Institute for Supply Management's purchasing managers' indices for manufacturing and non-manufacturing sectors. The ISM indices have historically been good early indicators of inflation. They have stopped falling but are at levels suggesting that inflation should decline further after having levelled off at around 3 per cent over the past six months.

Fixed income investments

Pace of central bank rate cuts will be crucial

In 2023 the spotlight was definitely on major central banks. Despite falling inflation, the US Federal Reserve (Fed), the European Central Bank (ECB) and Sweden's Riksbank hiked their key interest rates repeatedly during the first half. But during the second half, a surprisingly favourable inflation trend – together with emerging concerns about the damaging effects of their rate hikes on economic growth – persuaded these banks to take a more cautious approach. Late in the year, when their rhetoric signalled possible cuts as early as spring 2024, the market declared victory in the fight against inflation and reckoned that an economic hard landing would be avoided. With 2024 now under way, the market has shifted its focus to the pace and number of rate cuts expected during this calendar year – a focus that may certainly give rise to continued interest rate and bond yield movements.

Government bonds (excl emerging markets)

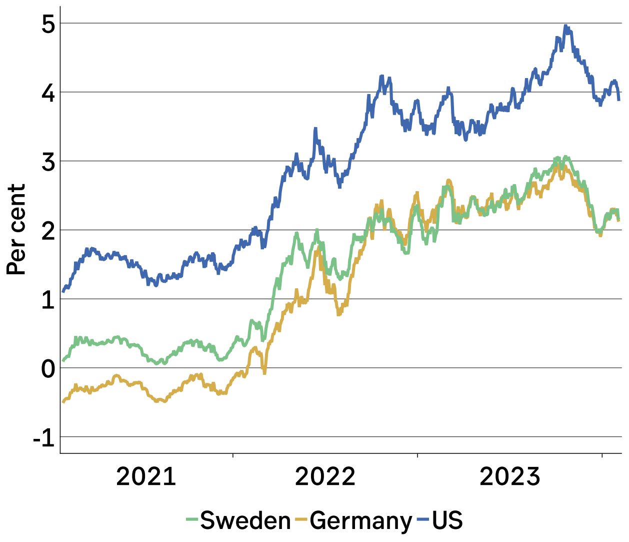
Downside inflation surprises and expectations of lower key interest rates led to a sharp decline in bond yields during the fourth quarter of 2023. Yield curves in the US, the euro area and Scandinavia are therefore still inverted, with long-term yields lower than short-term yields. The trend for long-term yields going forward depends mainly on changes in expectations about the upcoming interest rate cutting cycle. We see a limited downside for long-term yields, as long as the market does not factor in lower key rates than we have in our forecasts. Meanwhile, quantitative tightening (QT) and increased bond issuances will contribute to upward pressure on Swedish yields and widen the yield spread against Germany.

US – Historically, long-term yields tend to have a falling trend throughout a rate cutting cycle. Given already low long-term yields, the downside is relatively limited even if the Fed lowers its key rate to our forecast of 2.75-3.00 per cent by the end of 2025. Clearer indicators of labour market weakness may temporarily cause long-term yields to fall further, to levels that are unsustainable if there is confirmation of a soft landing this year. The bond supply will not be a key driver for 2024 yields, especially since this would be offset by the Fed most likely putting the brakes on its QT policy. In our view, 10-year Treasury yields will be 3.80 per cent in mid-2024, before increasing somewhat to about 4.00 per cent at year-end.

Euro area – Our forecast is that the ECB will start cutting its key rates in March. Its deposit rate will reach 2.00 per cent at the end of 2025. Long-term yields in core euro area countries are already low, and we expect only a slight downward movement over the next two years. The ECB has decided to reduce its holdings of securities at a faster pace starting in July, which will partly offset the effect of lower short-term yields. Our forecast is that German 10-year government bond yields will fluctuate around 2.00 per cent during 2024 and 2025.

Sweden – After gradually widening, the yield spread against German 10-year bonds narrowed towards the end of last year. We expect the previous widening trend to resume. Sweden's Riksbank has clearly indicated that its divestments of government bonds will increase again in February. We expect it to raise monthly volumes from SEK 5 billion to SEK 7-8 billion. The Swedish National Debt Office will probably also gradually increase the bond supply in 2024, when the Riksbank will receive a new capital injection (SEK 40 billion), and due to a larger government budget deficit. The yield spread against German 10-year bonds is expected to widen to 30 basis points by the end of 2024.

Large movements in long-term bond yields during the year



Source: Macrobond

After an extended upturn in government bond yields during the second and third quarter, yields fell sharply towards the end of 2023. That meant absolute yields were roughly the same at the beginning and the end of the year.

Government bond yield forecasts

10-year bond yields	Jan 18	June 2024	Dec 2024	Dec 2025
United States	4.14	4.80	4.30	4.00
Germany	2.31	2.75	2.60	2.50
Sweden	2.28	2.90	2.90	2.80

Source: SEB, forecasts January 2024

Yields have peaked, but there will be limited downturns in 2024. Given the sharp drop in long-term bond yields late in 2023, there will be little room for further declines. However, Swedish bond yields are expected to trend flat rather than fall.

Central bank interest forecasts

Central bank key rates	Jan 18	2024	2025
Federal Reserve	5.50	4.00	3.00
European Central Bank	4.00	3.00	2.00
Bank of England	5.25	4.00	2.75
Norges Bank (Norway)	4.50	4-00	3.00
Riksbank (Sweden)	4.00	3.00	2.25

Source: SEB, forecasts January 2024

Central banks are set to reverse their monetary policies. Assuming a favourable inflation trend and a fear of pushing economies towards a hard landing, they will cut their key interest rates rather aggressively over the next two years.

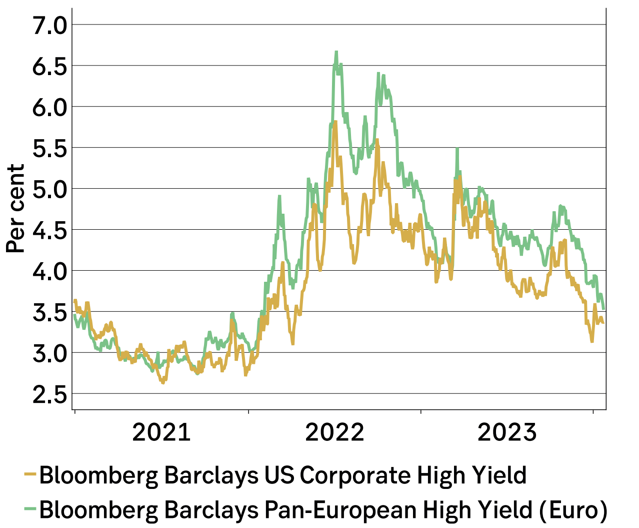
Corporate bonds – Investment grade (IG) and high yield (HY)

The corporate bond market ended the year quite strongly last year. Bond yields fell and yield spreads narrowed, moving closer and closer to historical lows. This was partly driven by resilient economic growth, which helped avoid the hard landing that the market had feared in early 2023. As a result, the increase in defaults on high yield bonds was limited to some extent. According to the credit rating institute Moody's, the default rate for 2023 is expected to end up at 4.6 per cent. The forecast for 2024 also looks relatively good, with the default rate expected to be around 4.5 per cent for the first few months before gradually falling, ending the year at around 3.8 per cent.

Another factor that contributed to the positive performance of corporate bonds was a relatively limited supply of refinancing options – that is, a supply driven by the issuance of new bonds to replace those maturing in the near term. However, this picture will change over the next three years as the share of global corporate bonds in both the investment grade and high yield segments rises. This means we will see an increased supply of new corporate bonds issued in the years ahead, as more and more companies need to replace maturing debt securities. Indirectly, it also means a relatively substantial increase in interest expenses for companies since their maturing bonds were issued when interest rates were much lower.

However, bolstered by our view that the global economy will undergo a soft landing, a larger supply of corporate bonds and higher interest expenses should be manageable in 2024. On the other hand, the return potential from falling bond yields and narrower credit spreads will be more limited in 2024 after the sharp movements we experienced at the end of 2023. Long-term bond yields are expected to trend flat in Europe, while there is room for a small downturn in the US. Credit spreads are currently at historical lows, which means there is limited scope for further narrowing.

High yield credit spreads back at historical lows



Source: Macrobond

After US banking sector stress was isolated, credit spreads gradually narrowed during the rest of 2023 and were at historical lows by year-end.

Emerging market debt (EMD)

Emerging market (EM) bonds, like the rest of the fixed income market, generated good returns over the past year, no matter whether investors held corporate bonds or government bonds (sovereign debt). This is rather impressive, since the year saw four Fed interest rate hikes, fears of a US recession, banking sector stress and a Chinese real estate market in turmoil – all factors that constitute clear headwinds for emerging markets.

Looking ahead, there are reasons for continued optimism. Economic growth in emerging economies still looks stable and is expected to end up at around 4 per cent in 2024, down marginally from last year but nonetheless in an expanding phase. Because growth in the advanced economies is expected to slow down even more, this should mean a wider gap in growth rates during 2024.

The inflation outlook also looks favourable, both from a domestic and a US perspective. Inflation in emerging market countries is continuing downward, aided by falling commodity prices, which makes room for key interest rate cuts. The decline in US inflation has also been favourable to the EM sphere. Regardless of whether the Fed postpones its first rate cut, emerging economies should be able to lower their rates based on their own conditions.

One risk factor that might cloud the above relatively bright outlook is if US inflation proves more persistent than expected or rebounds and forces the Fed to unexpectedly carry out one or more interest rate hikes. This scenario would probably lead to higher yields on USD-denominated debt and a stronger USD in the initial phase. In the longer term, the risks of an economic hard landing would also increase, which would cause currently narrow credit spreads to widen and thus have a negative impact on EMD prices.

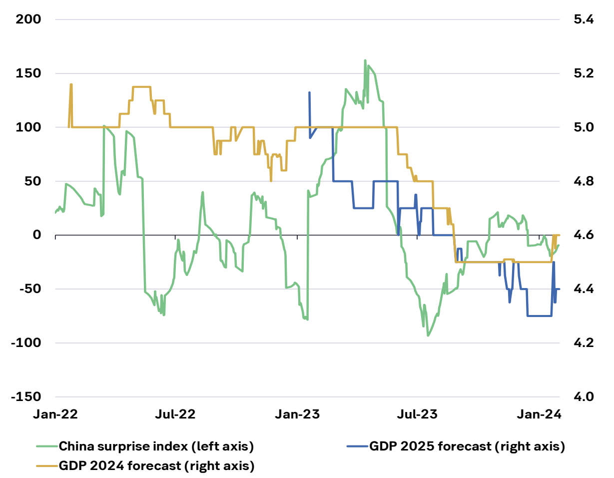
Theme: China
A focus on "modern industrial systems"

Building "modern industrial systems" is now a top priority for policymakers in Beijing, and they have increased their policy focus on ensuring reasonable economic growth in 2024. China faces an economic landscape that is affected by everything from challenges in the real estate sector to the surprising renaissance of the automotive industry.

Beijing has increased its policy focus on ensuring reasonable economic growth in 2024

Favourable base effects pushed 2023 growth above the official target of "about 5 per cent". With fading base effects, Chinese officials need to ramp up fiscal support in order to reach reasonable growth this year. We expect GDP to rise by 4.6 per cent, even as the real estate sector contracts for another year. But the renaissance of the automotive sector, along with the growth of other priority sectors, should still provide some positive surprises to growth. Despite some stabilisation in activity in the certain sectors, analysts remain wary about bumping up forecasts for this year. Beijing will not release official economic targets until March.

2024 GDP forecasts have not yet improved



Source: Bloomberg, SEB

The policy pendulum is swinging in favour of growth

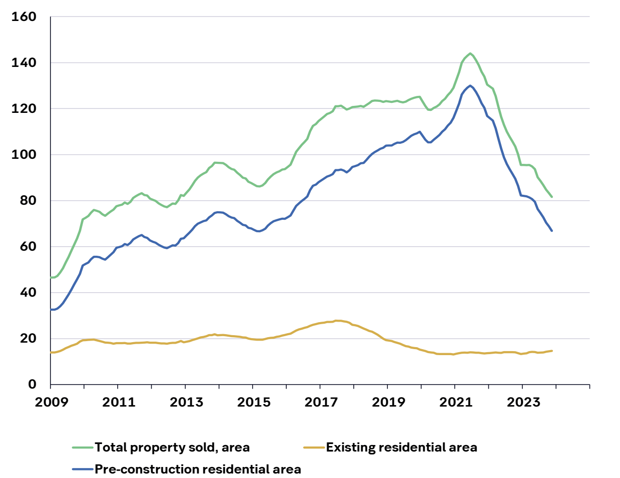
In mid-December 2023 the Central Economic Work Conference (CEWC) – the yearly meeting that sets the country's economic agenda for the following year – even indicated that non-economic policies will be incorporated into the assessment of macro policy consistency. Simply put, officials across the various centres of power will be held accountable to ensure that overall policies will not have a negative impact on growth.

Beijing is now ready to shoulder some of the fiscal responsibility

For a long time, local governments have been tasked to deliver on growth-boosting projects. Yet with subdued revenues and the pressure to re-absorb off balance sheet debt issued by local government financing vehicles (LGFVs), local authorities have had little room to pursue public sector investments. As a result, growth in infrastructure spending was weak at less than 6 per cent. In October 2023, the central government issued a supplementary budget of around 0.8 per cent of GDP. The proceeds of the additional funding were allocated to local governments, keeping the momentum of activity up through Q1 2024.

The release of economic targets in March will include bond quotas for both central and local governments. Because the central government partially front-loaded its deficit spending in 2023, there is only room for Beijing to announce a small bump in the planned deficit for 2024. Meanwhile, if China were to target GDP growth above 4.8 per cent, then the bond quotas for the local governments would need to be increased substantially. In any case, fiscal policy will keep bond supply elevated through the year. To limit volatility in onshore interest rates, we expect the central bank to raise liquidity injections and maintain an easing bias.

Property sales have fallen to 2013 levels



Source: Bloomberg, SEB

The real estate sector will continue to contract in 2024

Since real estate sales started to decline in late 2021, more than 50 per cent of listed developers have either defaulted or restructured their public bonds. Those refinancing challenges of the developers were exacerbated by a loss of confidence from homebuyers. At the peak of the real estate cycle, more than 90 per cent of all transactions in China were pre-construction sales. By the time the property is completed, homebuyers would have already paid more than 50 per cent of the value of their property. Meanwhile, pre-construction revenues make up a large percentage of funding for the developers. Despite numerous policy adjustments designed to boost demand for new homes, households remain wary of the remaining real estate developers. As a result, pre-construction sales have now collapsed to levels last seen in 2013. As long as households doubt the ability of developers to complete outstanding projects, pre-construction sales will probably continue to decline. With tight funding capabilities, developers will have a limited project pipeline, possibly through 2025. Overall, this will remain a dampener on construction activity.

The outlook for priority sectors remains optimistic

Beijing has elevated industrial policy to its top priority for this year. This is in contrast to 2023, when its priority was to ensure the recovery of domestic consumption. "Building modern industrial systems" is now top of mind for policymakers. The development of high-tech manufacturing has been a sectoral priority for years. It is not a surprise that even with weak infrastructure spending, investments in priority manufacturing sectors rose at a double-digit pace in 2023. At the heart of China's industrial policy is boosting capabilities in the automotive sector, battery manufacturing, the green energy transition and the health sector. In light of the ageing population, Beijing has been raising investments in goods and services that will benefit the senior population. Building on these capabilities will likely continue in 2024.

The renaissance of the automotive sector goes beyond electric vehicles

The electrification of the domestic auto market has come in faster than even the government's target. By end-2023, new electric vehicles (NEVs) made up more than 32 per cent of new car sales. The uptake in tier-one cities may have already reached more than half of sales. With continued investment in charging infrastructure throughout the country, sales of NEVs will likely continue to surge. As a result, a Chinese EV manufacturer is now the top-selling car brand in China, a designation long-held by a German brand. The industrial policy that has long focused on building NEV capabilities has widened the gap between Chinese NEV technology and traditional European brands. The taste of Chinese consumers has also shifted in favour of smart vehicles.

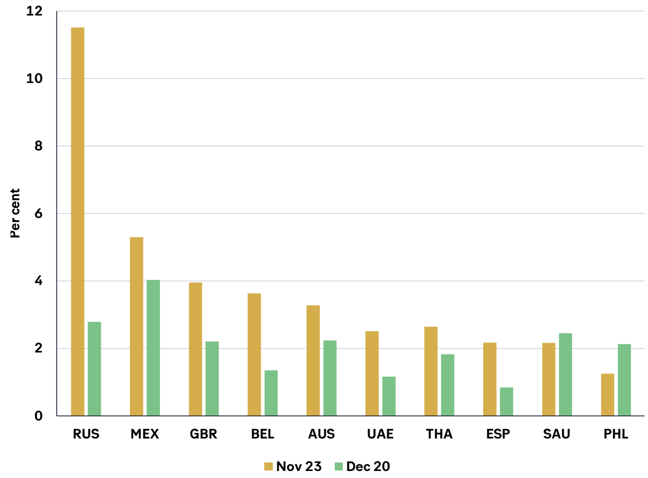
Meanwhile, sales of internal combustion engine (ICE) vehicles have also turned positive

After years of contracting volumes, ICE car sales grew almost 9 per cent in 2023, pushing up overall sales for the year. Yet, even with strong sales volumes, overcapacity in the domestic market has intensified pressure to cut prices. With more than 100 car brands in China, this aggressive price war has squeezed corporate margins throughout the automotive sector supply chain. Already, more than half of car brands are not profitable. It is expected that most home-grown brands will not survive as industrial subsidies fade.

The export market provides another tailwind to the auto sector

Auto exports rose around 30 per cent in 2023. Since the war in Ukraine began, Russia has emerged as the top market for Chinese-made vehicles. While it is likely that most exports to Europe are electric vehicles, the diversified export market suggests that there is also demand for Chinese petrol-powered cars. Although it is still uncertain whether the European Union will impose trade restrictions on Chinese-made EVs, there are other markets where automakers can still expand their presence, like ASEAN, Latin America, the Middle East and Africa.

China is exporting cars to a diversified basket of economies



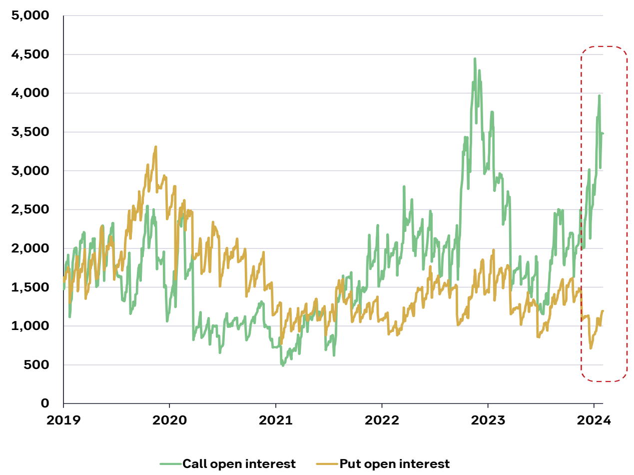
Source: CEIC, SEB

Despite persistently weak sentiment, the stock market must prepare for upside growth surprises

After three years of disappointing equity market performance, the market is cautious about yet another sombre year. Large-cap ETFs have already lost around 10 per cent in the first weeks of 2024. Yet option traders are ramping up positions that will take advantage of a possible turnaround in Chinese equities.

Read more about our thoughts on China and its stock market in the global equities section, starting on page 10.

Option traders are preparing for upside gains in stocks



Source: Bloomberg, SEB

Theme: Greater circular material flows will create opportunities

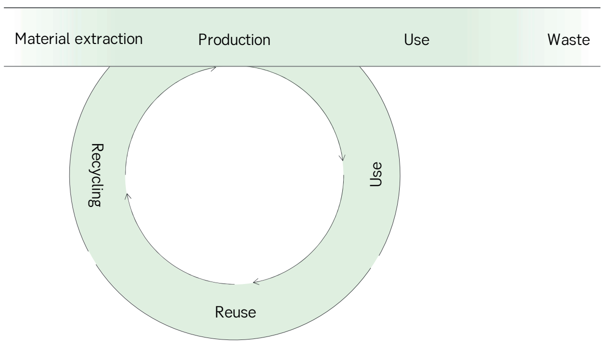
In today's linear economy, where overconsumption of resources risks leading to serious consequences, the transition to a circular economy is increasingly necessary. With only 7.2 per cent of materials reused or recycled, the Circularity Gap Report highlights the urgent need for change. The aim of a circular economy is to maximise the use of materials and products and minimise the use of raw materials.

In today's linear economy, 75 per cent more resources than the earth produces are consumed each year. If this overuse of global resources continues, we would need as many as three earths by 2050. Meanwhile more than 90 per cent of the materials we consume are discarded or unavailable for reuse after being used in only a single product. In 2023, only 7.2 per cent of all input materials came from reused or recycled materials, according to the Circularity Gap Report, which was launched at the 2018 World Economic Forum in Davos. These figures, together with the most recent changes in the geopolitical landscape and volatile commodity prices, demonstrate the need for the transition to a circular economy.

In a circular economy, the goal is to use all materials and products as many times as possible and minimise the share of raw materials used in new products. At the end of a product's service life, the material is then recycled to the greatest extent possible. This is in contrast to the linear economy, which essentially involves extracting natural resources to make products that are used and then thrown away.

Making the transition to a circular economy requires major changes in our view of how value is created and maintained in the economy, the kind of business models that companies use and the way materials are managed. The traditional linear economy is built on product sales and value creation by generating revenue in the short term. Successful companies have historically focused on increasing their revenue from manufacturing new products with a short lifespan. A circular economy is instead characterised by a greater focus on services and long-term value creation through reuse and recycling aimed at extending a product's service life. Companies that are adept at exploiting the value of their products and materials and use new service-focused business models will therefore probably be the most successful in the transition to a circular economy.

The linear and the circular economy

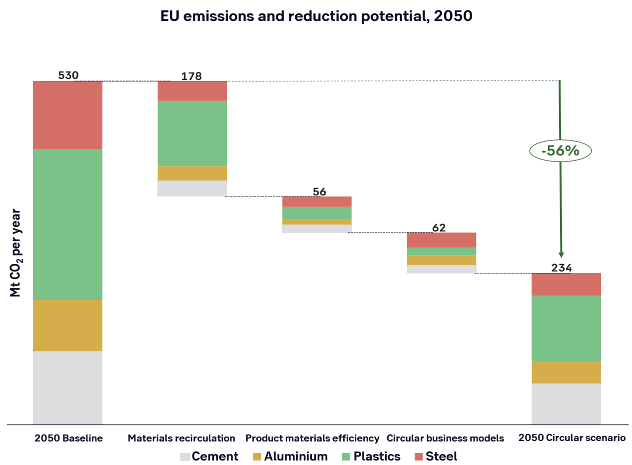


Source: SEB Climate & Sustainable Finance

In a circular economy, the focus is on the reuse and recycling of products and materials in order to avoid throwing them away.

Today the extraction of new materials accounts for roughly 70 per cent of global greenhouse gas emissions. Emissions are generated from energy use, among other activities, so one obvious measure that is often highlighted is to increase the use of renewable energy. Such a transition to renewable energy has the potential to cut greenhouse gas emissions about 55 per cent by 2050. Nonetheless, that is not enough to avoid the serious consequences of climate change.
The circular economy will thus play a key role in reducing emissions and achieving global climate targets, but this will also require a major shift in today's material flows. According to the UNDP Climate Promise, circular material flows in four key sectors (cement, steel, plastics and aluminium) can lead to a decrease in global greenhouse gas emissions by a full 40 per cent by 2050. In the European Union, circular material flows have the potential to cut emissions from these sectors by more than half during the same period.

Potential to cut emissions in four key EU sectors by more than half by 2050



Source: Material Economics, *The Circular Economy* (2018)

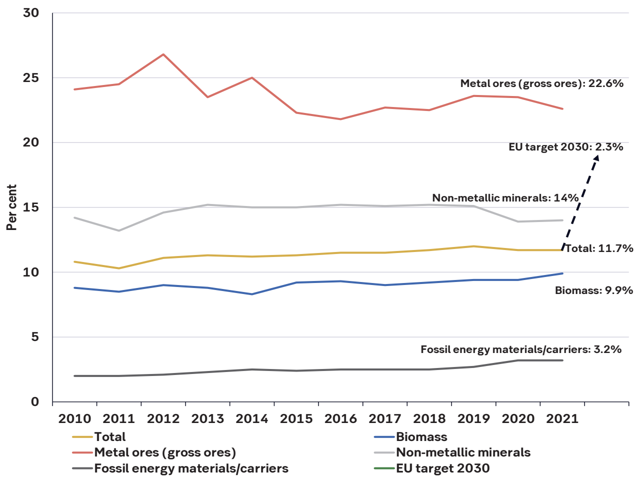
The chart shows potential EU emission reductions through circular material flows and circular business models in the steel, plastics, aluminium and cement sectors to 2050. The biggest decrease in emissions will come from increased materials circulation.

From an economic perspective, it is also logical to design a system that avoids disposal of waste and keeps materials in use for longer. In today's linear economy, we use large quantities of natural resources that are quickly discarded, which in the long term means a loss of economic value. For example, in the EU steel, plastics and aluminium sectors, EUR 78 billion is lost each year after just one material use cycle. Circular material flows can help to maintain the value of products and materials for longer and thus contribute more economic value to businesses and society in general.

In recent years, a focus on the circular economy has also moved higher up the political agenda for strategic reasons. Circulating materials can reduce dependency on imports from other regions, which is an increasingly important issue in today's geopolitical climate. For example, between 75 and 100 per cent of all metals used in the EU are currently imported. This entails a great risk since access to these commodities will be essential for a successful energy transition. A discussion is thus under way in the EU on how the region can become more self-reliant. This dependency can probably not be eliminated solely through increased metal extraction within the EU. Companies that enable the reuse or recycling of these materials in a circular flow will therefore probably play a key role.

The circular economy's role in mitigating climate change and reducing import dependency is reflected in a wave of new and upcoming regulations in this field. They may serve as a catalyst in the transition to a circular economy. One example is the EU's Circular Economy Action Plan, which comprises a total of 35 regulations and initiatives to support the transition. The action plan also includes an ambitious target of doubling the share of recycled materials used in the EU economy between 2020 and 2030.

The EU's target is to more than double the use of recycled materials by 2030



Source: European Environment Agency, The Circularity Gap Report, SEB Climate & Sustainable Finance

The chart shows the share of recycled materials in production (circular material use rate, CMUR) in the EU between 2010 and 2021 by material category and the target for 2030.

The transition to a circular economy offers exciting new business opportunities to companies that can take advantage of upcoming regulatory changes and increased demand for their circular products and services. The management consultancy Material Economics estimates that EUR 515 billion in new EU revenue can be generated each year before 2030 in waste management, battery production, plastics and circular building materials. We thus believe that there are good growth opportunities even today for companies that promote or work innovatively with the circular economy in various ways.

Focus: Circular material flows as an investment opportunity

We are still only at the beginning of the transition to a circular economy, which requires both an adjustment in material flows and implementation of new, often service-focused circular business models. This may include product-as-a-service business models, which in their purest form involve the manufacturer continuing to own and maintain a product while the customer leases it for use. These kinds of circular business models are still very rare in many sectors. We predict that increased use of circular material flows will be one of the first steps in the transition to a circular economy. Investing today in companies that specialise in circular material flows will not only help to accelerate the transition to a circular society, but will also provide an excellent opportunity to take advantage of growth potential in companies with new business concepts and innovative technologies, since these companies may be the first to benefit from the circular economy as an investment theme.

Many different companies are involved in a circular material flow. We have identified an ecosystem consisting of four types of market participants that can contribute to increased circulation of materials:

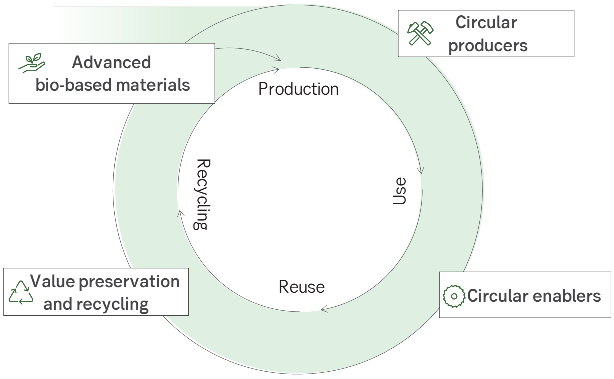
1. **Advanced bio-based materials.** Companies in this category produce materials from renewable or biodegradable resources that replace non-renewable raw materials. The materials produced are easy to recycle or reintroduce into the ecosystem after use. This group may include companies that use new technologies to transform biomass or other biodegradable materials into products not normally considered renewable, such as plastics.

2. **Circular producers.** A circular producer focuses on circular material flows in both its design and production process. Products are designed so that they can easily be reused or recycled, something that may otherwise be very difficult. Companies in this category are leaders in circular thinking, for example, with their advanced buy-back and recycling schemes. This means that manufacturers take greater responsibility throughout a product's life cycle to ensure that the product or its materials are recirculated.

3. **Circular enablers.** This category consists of companies that make circular material flows possible, for example by offering resale platforms. A circular enabler may produce equipment or technologies needed to recycle materials.

4. **Value preservation and recycling.** Companies in this category are active in recycling or refining materials or products at the end of their life cycle. The goal of these companies is to close the circle and enable the reuse of materials in new products. As a result, the value of materials is maintained. This may involve companies that work with traditional recycling through collecting and managing waste. However, in most cases these companies work with new methods to recycle materials that could not previously be recycled, for example, chemical recycling of plastics.

SEB's ecosystem for circular material flows



Source: SEB Climate & Sustainable Finance

An ecosystem for circular material flows with four types of market participants.

This definition of ecosystem has been developed by SEB and is based on the Ellen MacArthur Foundation's definition of a circular economy. The concept can be used to identify investment opportunities in these four categories of companies. Naturally, there are more than four types of market participants in a circular ecosystem, but we have chosen to focus on these investment opportunities.

> *"More than 90 per cent of the materials we consume are discarded or unavailable for reuse after being used in only a single product."*

Many companies that work with circular material flows are still relatively small firms that develop new products and technologies. A large number are startups that launched during the past five years and have seen strong growth during this time but in many cases are not yet listed. Investing in listed shares that fall under this investment theme is thus challenging. Our ecosystem concept may thus help investors to identify liquid stocks whose future performance may be positively affected by a circular economy transition. A selection of European and North American listed companies that have a clear exposure to circular material flows is presented below.

Advanced bio-based materials – Borregaard ASA

The Danish company Borregaard produces advanced bio-based chemicals that can replace fossil-based products. Borregaard's biorefinery converts wood into cellulose and a number of other valuable products. By-products from the making of cellulose are first used for the production of bioethanol before residual materials are converted into lignin-based biopolymers. By-products that cannot be used in new products are converted into biogas or biomass and used for energy in the production process. With this production method, 94 per cent of the wood is used – 82 per cent is converted into commercial products and 12 per cent into energy.

Borregaard has a diversified product portfolio and a global customer base. The company states that it is well positioned to capitalise on the growing trend towards bio-based products. Borregaard contributes to circular material flows by both creating bio-based products and minimising the share of materials that are discarded.

Circular producers – SKF

The Swedish engineering company SKF is a sector leader in reusing and recycling materials. It has developed a number of initiatives to extend the service life of components and systems and to close the circle at the end of a component's life through recycling. SKF's expertise in rebuilding industrial bearings gives them new life or enables their reuse. Bearings not suitable for rebuilding are recycled to produce new bearings, which in effect closes the circle. The remanufacturing of bearings also entails lower costs over the bearing's life cycle.

Today SKF has more than 15 bearing remanufacturing centres across the world. The company has provided such services to heavy industry for 25 years and has seen a steady rise in demand for remanufactured products. As a result, in 2020 SKF also set up its first circular economy centre in Gothenburg, a local unit that provides circular solutions close to its customers. Demand for the centre's services has quadrupled in just two years.

Circular enablers – Tomra Systems

Norwegian-based Tomra's vision is to lead the resource revolution. Its reverse vending machines (RVMs) collect glass bottles, PET bottles and aluminium cans, enabling the recycling and reuse of materials. Tomra has installed more than 80,000 such machines globally so it is playing an important role in the transition to circular material flows. Along with its machines for recycling beverage containers, Tomra has expanded into the market for waste sorting and sensor-based food sorting.

Tomra is the world leader in manufacturing RVMs, with a market share of 75 per cent globally. Going forward, the company may benefit from the introduction of new beverage container return systems in the EU, which is governed by regulations such as the EU Packaging and Packaging Waste Directive. This may increase growth in Tomra's collection and recycling operational segments.

Value preservation and recycling – LanzaTech

US-based LanzaTech has developed technology to make use of emissions from heavy industry to create new products. The main product produced so far is ethanol, which can be converted into a number of different chemicals. For example, LanzaTech has demonstrated that it can produce ethylene from captured carbon dioxide. This chemical compound is sold in large quantities, with an estimated global market worth USD 170 billion by 2030. LanzaTech has also entered into a partnership with the Swedish energy company Vattenfall, Scandinavian Airlines (SAS) and Shell, aimed at exploring the potential for the world's first large-scale production of sustainable aviation fuel (SAF) in Sweden. The goal is a new production facility that could produce up to 50,000 tonnes of SAF annually. In full production, it could provide SAS with up to 25 per cent of its SAF needs by 2030. With its technological know-how, LanzaTech has the potential to capitalise on two major sustainability trends – climate change adaptation and circularity.

Value preservation and recycling – Loop Industries

Canada's Loop Industries has developed a technology that enables the recycling of plastics which could not previously be recycled. The method breaks down PET plastic and polyester fibres into their original building blocks and then puts them back together. As a result, the company can produce new materials that are 100 per cent recycled, from materials that are normally not recycled and would otherwise end up as landfill. The materials can be reused any number of times, without reducing quality or purity. Recycling is carried out at a low temperature and without increasing pressure on the material, which means that the process is less energy-intensive than other recycling methods. The company currently has a demonstration facility in Quebec. In 2023, Loop Industries and the South Korean petrochemical producer SK Geo Centric formed a joint venture that will build at least four commercial facilities using Loop's technology. Loop Industries also has partnerships with a number of other global corporations, such as the French utility company Suez and the global PET resins producer Indorama Ventures.

International overview

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

Greater predictability in a still turbulent world

Despite geopolitical tensions, we are starting 2024 with a dash of optimism. Many economies have moved in the right direction this autumn and winter. The slowdown is much as expected, risks are balanced, and our soft-landing scenario is alive. The inflation downturn is stirring hopes of key rate cuts, some as early as this spring. Employment will remain high, and household purchasing power will return. But overshadowing this are new conflicts, a record-warm 2023 and increased tensions as relations between countries, trade and industrial policies are reassessed.

The new year began with mixed impressions, to say the least. Economic predictability has increased, but this is happening in a more and more unpredictable world. The global security situation is serious and has become worse in recent years – with continued Russian aggression against Ukraine, clear risks that the war between Hamas and Israel may spread, attacks on shipping in the Red Sea and increased tensions in East Asia. Meanwhile, there are good reasons for economic optimism now that inflation is falling, in line with our earlier forecasts. This will also accelerate central bank rate cuts, resulting in less restrictive monetary policies during 2024-2025.

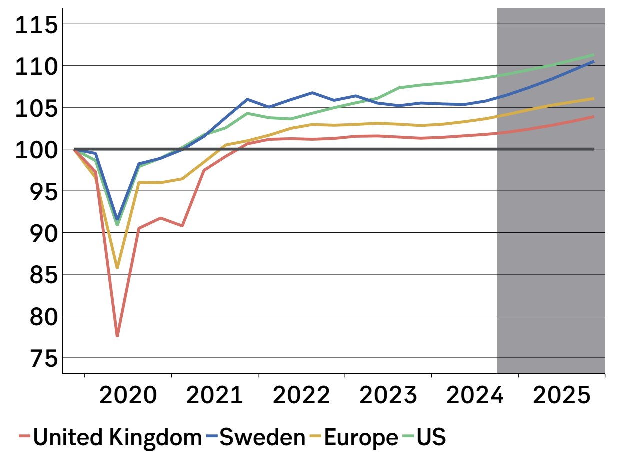
A generally positive economic outlook

The global economic outlook is generally positive. It is true that 2024 growth will be anaemic, especially in Europe, and labour markets will deteriorate moderately. But the foundations are being laid for a recovery in 2025, despite an environment of heightened security policy concerns. We continue to have a more positive view of inflation than the consensus, which is crucial for our central bank forecasts. We believe that big declines in GDP are not needed to bring down inflation. The European Central Bank will be the first to cut interest rates in March, followed by the US Federal Reserve and Sweden's Riksbank in May. This will provide support to interest-sensitive sectors. Lower inflation will boost household purchasing power. A more predictable economic world will support risk appetite and global stock markets, while stimulating consumption and investment.

Not a risk-free world

Quick turnarounds are fraught with risks. The interest rate wall erected by central banks may lead to delayed negative effects on both the real economy and the financial system. We also foresee a risk of setbacks in the battle against inflation, leading to repricing of rate cut expectations. The super-election year 2024 may bring major changes in global economic and security policy cooperation and steps towards a more polarised world if the US elects a new president.

Soft landing



Source: Macrobond , SEB

Our main scenario is a relatively short and shallow deceleration in US growth and a return to positive growth in Sweden and Germany.

A slowdown in growth – clear but mild

We are seeing a clear slowdown in growth in many countries, but it is surprisingly mild compared to the shocks and crises of recent years. There are continued differences between countries and sectors, but our forecast revisions are minor. Many countries will achieve a soft landing, avoiding deep economic downturns and sharply rising unemployment. This scenario runs counter to historical patterns, which have instead shown that high inflation could only be brought under control by a sharp economic slump. So far, statistics support the view that this cycle may be an exception. We still believe that a soft landing is possible. Yet the fact remains: global growth of 3 per cent or less is anaemic from a historical perspective.

Global GDP growth, %

Market	2022	2023	2024	2025
United States	1.9	2.4	1.6	1.8
Japan	1.0	1.7	1.2	1.2
Germany	1.8	-0.3	0.0	1.6
China	3.0	5.2	4.6	4.4
United Kingdom	4.3	0.5	0.2	1.4
Euro area	3.4	0.5	0.5	1.8
Nordic countries	2.7	0.1	0.8	2.4
Sweden	2.6	-0.4	0.1	2.8
Baltic countries	2.0	-1.0	1.2	2.9
OECD	2.9	1.6	1.4	2.0
Emerging markets	3.7	4.3	4.1	4.0
World, PPP*	**3.3**	**3.1**	**2.9**	**3.1**

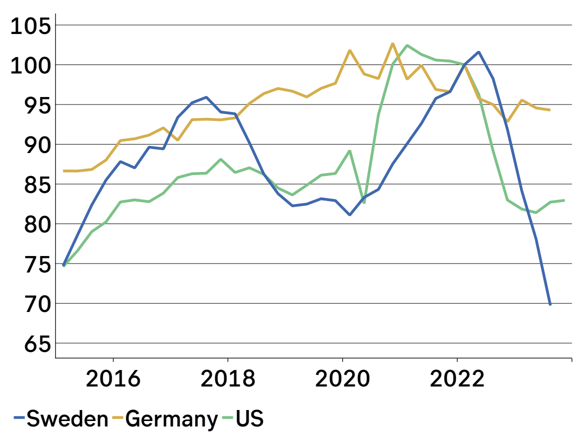
Source: SEB Nordic Outlook

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

US strength and German weaknesses

In the US, growth and the labour market have remained resilient, while inflation and pay increases have slowed. We expect a late 2023-early 2024 slowdown in quarterly growth, but it will remain positive. In the euro area, growth is hovering around zero. Germany is the worst performer, as weak global demand combines with high energy prices and constrained fiscal policy to reduce growth (see the theme article on page 35). Sentiment indicators point to weaker overall growth, but no collapse. Housing investments have been a drag on growth in many countries but other capital spending – including public sector investments – has been surprisingly strong. Emerging market (EM) economies are growing in somewhat more stable fashion, but China is struggling to boost demand as households increase their savings, real estate sector woes continue and geopolitical tensions diminish trade.

Residential investments



Source: Bureau of Economic Analysis (BEA), German Federal Statistical Office, Statistics Sweden (SCB), Macrobond, SEB

International housing investments are weak, but nowhere near the abrupt deceleration we are seeing in Sweden.

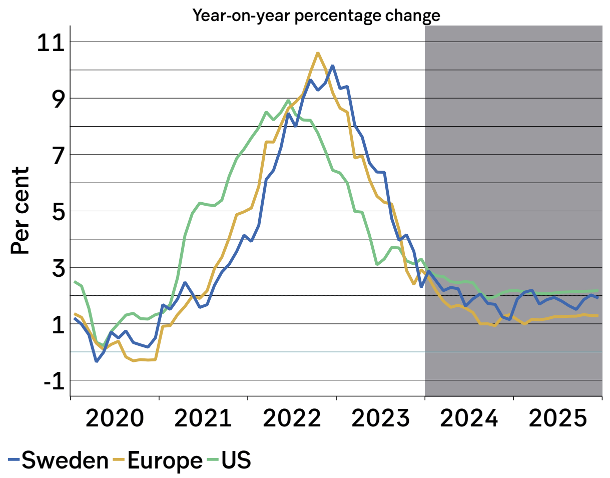
Inflation developments will be crucial

Aside from changes in the security policy situation, inflation is a crucial factor behind monetary policies and interest rates, household purchasing power and business investments. Although there are still question marks over underlying price pressures from services and wages, there are signs that inflation is falling towards central bank targets. Our forecast implies that both total and core inflation will reach Fed, ECB and Riksbank targets within a few months. Weaker economic conditions and high inventory levels are forcing many companies to refrain from price hikes and adjust production levels. Base effects (when a new low-inflation month replaces a high-inflation month in 12-month change figures) also play a role, but we foresee a broader inflation downturn.

A focus on price momentum

Year-on-year inflation rates provide a retrospective view of price developments and do not fully illustrate the recent inflation downturn. To capture current price momentum, monthly figures (or price changes over the past three months to smooth out the trend a bit) are more in focus. The latest annualised monthly figures indicate an inflation rate of close to 2 per cent. We believe this downward trend will continue, which implies that in a few months we should have inflation figures even data-dependent central banks can view as persistently low enough to launch rate cutting.

Inflation is approaching 2 per cent



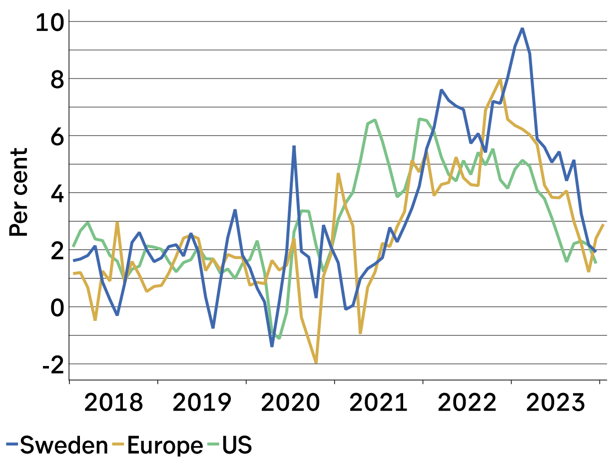
Source: Macrobond, SEB

During 2024, inflation will fall to or below central bank targets. This will pave the way for key interest rate cuts.

Both supply- and demand-side factors are supporting lower inflation

The key rate hikes of the past two years have had an impact, easing demand pressure in the economy. On the cost side, broad producer prices are falling, partly because most commodity prices have fallen and global value and transport chains have normalised. At this writing, events in the Red Sea are an uncertainty factor that may lead to short-term production disruptions and inflationary impulses. But we do not consider these disruptions sufficiently widespread to fundamentally change the picture of falling global inflation.

Core inflation around 2 per cent



Source: U.S. Bureau of Economic Analysis (BEA), Eurostat, Macrobond, SEB

In recent months, so-called core inflation (an important measure for central banks) has been around the target level of 2 per cent.

New inflationary environment?

The shocks and crises of recent years have clearly shown that we cannot take inflation of, or near, 2 per cent for granted. Inflation is on its way down, but many forces now at work could change the inflation environment going forward – on both the upside and the downside. The energy transition is one example; at least during a limited period, it may lead to higher and more volatile prices. Similarly, artificial intelligence (AI) developments may potentially improve productivity and push down inflation, but their impact is uncertain in terms of timing and location.

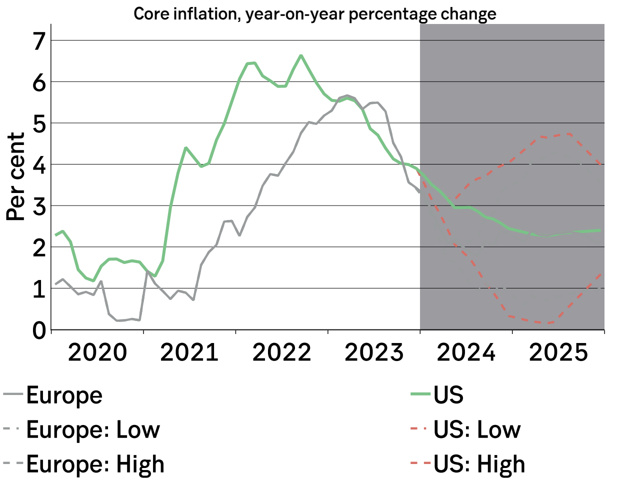
Favourable inflation outcomes are very likely

We interpret the recent downturn in inflation as a sign that demand has also eased, in line with lower economic activity. Slightly higher pay increases than the historical patterns in various Western countries are a concern, but since we are now in a situation where inflationary forces are working more broadly in the same direction, we see a somewhat greater likelihood that inflation will surprise us on the downside than on the upside. The inflation outlook is currently surrounded by unusually high uncertainty, however. This risk situation and factors that might trigger a lower, or higher, inflation path are illustrated below.

Are we underestimating the downtrend in inflation?

The strength of the inflation upturn in recent years surprised most people. Especially last autumn, we have saw that the downward trend has been strong – in some cases surprisingly so – and that high inflation figures were temporary. But even if inflation slows, the level of prices will remain well above its historical trend. In our main forecast, most prices will also remain high. But this is not certain. Yet if we imagine that one third of the price increases for goods, food and some services would be reversed, then core inflation would fall below 1 per cent by the end of 2024 and stay at that level in 2025 as well, while total inflation would drop below zero. Such a development would fuel demand via real incomes and larger interest rate cuts. We would probably also see faster growth in countries with high interest rate sensitivity, such as the Nordics.

Inflation scenarios



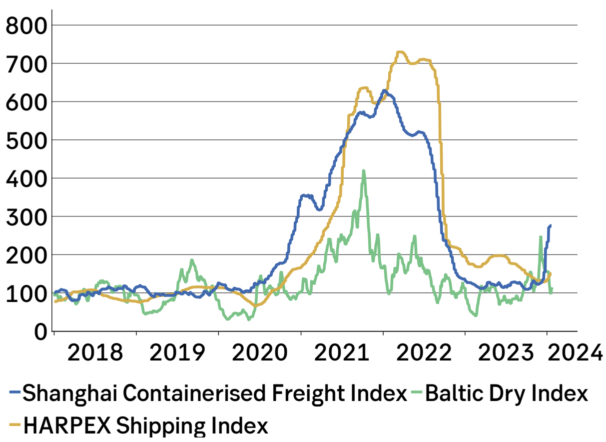
Source: Macrobond, SEB

If growth and labour markets continue to surprise on the upside, inflation could rise again. On the other hand, price reversals can result in far lower inflation than forecast.

Geopolitics may fuel a new burst of inflation

The energy price shock of 2022 was a clear example of how quickly economic conditions can change. In our high-inflation scenario, we assume a series of events resembling the 1970s, when inflation rose in two cycles, both triggered by rising oil prices. In this case, we expect that the second wave (contrary to the situation in the 70s and 80s) will be milder than the first and that it will be driven by higher energy and food prices, with spillover effects to other goods and services. Given a higher price upturn, central bank policymakers would face an even harsher dilemma – tightening monetary conditions to bring inflation under control while growth decelerates further. Both short-term rates and long-term yields would rise. Households that are already under financial pressure would cut back on consumption, and the decline in home prices would speed up again, especially in interest rate-sensitive economies.

Some freight prices are accelerating



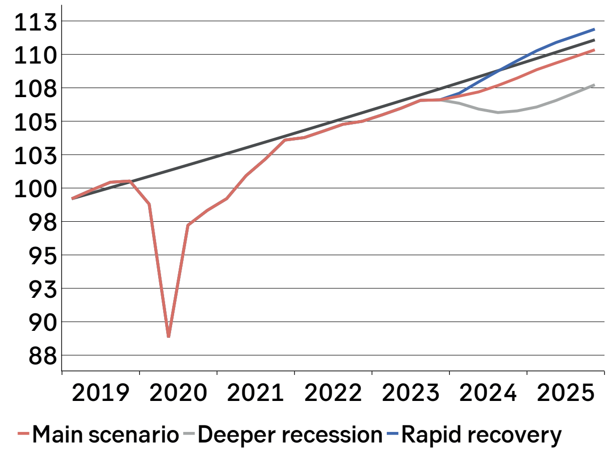
Source: Baltic Exchange, Harper Petersen & Co., Shanghai Shipping Exchange, Macrobond, SEB

Geopolitical turmoil has pushed up freight prices again. If this trend is prolonged, it could help lead to higher inflation.

Balanced risk outlook for global growth

In our 2023 *Nordic Outlook* updates, we viewed risks as balanced or slightly on the downside. Underestimated interest rate sensitivity, geopolitical events and financial risks drove downward scenarios during the year. The theme of our positive growth scenarios was consistently linked to favourable inflation surprises.

Scenarios for growth in the OECD countries



Source: Macrobond, SEB

As usual, there are growth risks on both the upside and the downside. We consider these to be balanced.

Alternative inflation paths may lead to better or worse growth

Many uncertainties about inflation, central bank policies and the slowdown in growth have been clarified, and we now view the risk outlook for our positive and negative scenarios as balanced. Inflation plays the main role in both cases this time around. Our growth scenarios are not directly linked to our alternative inflation scenarios, which illustrate possible paths. As described above, a faster downturn in inflation would lead to better real incomes and a faster decline in interest rates, enabling capital spending to accelerate. On the other hand, the geopolitical situation is more inflamed than for a long time. Large fluctuations in fixed income market pricing and last autumn's stock market rally are causing concern about possible setbacks. If the conflicts in the Middle East escalate – with rising energy and freight prices as a result – a repeat of the inflation upturn in 2021-2022 will not be far away. Since unemployment is relatively low in many countries, we see less upside potential in our positive scenario than downside divergence in our negative one.

Scenarios for the OECD countries

GDP growth, per cent	2022	2023	2024	2025
Main scenario	2.9	1.6	1.3	2.0
Negative scenario			-0.2	0.9
Positive scenario			2.1	2.6

Source: SEB

Growing rivalry is changing the world

Global cooperation is being put to several tests. After 30-40 years of deregulation in global trade and growth in multilateral cooperation, the world is now taking steps in the opposite direction. The COVID-19 pandemic, the war in Ukraine and increased tensions between the US and China, among other developments, show the vulnerability of global value chains and the risks that have built up in a number of strategic areas. The previously optimistic (or naïve) view that trade democratises the world and makes conflict impossible is now being abandoned and replaced by trade barriers, tariffs and subsidies.

Globalisation is being replaced by regionalisation and fragmentation

This development is partly driven by a desire to correct past mistakes and market failures, but it also includes clear elements of protectionism, with politicians wishing to promote domestic production and take back national control over industrial policy (see the theme article on page 18). The extent of these changes and their economic impact – on capital flows, investments, prices, etc. – are uncertain, but these are issues we must deal with in the future. It is especially important to small export-dependent countries such as the Nordics to ensure that the European Union has a strong voice when new regulations are hammered out.

Interest rate cuts will dominate 2024-2025

Late in 2023, several central banks confirmed that their key interest rate had peaked. Meanwhile the Fed and others opened the door to looser future monetary policies, including lower key rates. Falling bond yields and rising stock markets have already helped ease financial conditions. Our key rate forecasts from last autumn have been confirmed, supported by continued declines in core inflation and inflation expectations. The ECB will be the first central bank to cut key rates in March, while the Fed and the Riksbank will wait until May. The Bank of Japan will go its own way, abandoning its negative key rate this year but remaining at an extremely low 0.10 per cent at the end of our forecast period. Although the peak in the US key rate has become shorter according to the latest market pricing, it is not extremely short from a historical perspective. Assuming a Fed rate cut in May, it will be 9 months long. Since the 1990s, these peaks have varied in duration between 5 and 18 months.

Central bank key interest rates, % at year-end

Central banks	Jan 18	2024	2025
Federal Reserve	5.50	4.00	3.00
ECB*	4.00	3.00	2.00
Bank of England	5.25	4.25	3.00
Norges Bank (Norway)	4.50	4.00	3.00
Riksbank (Sweden)	4.00	3.00	2.25

*Deposit rate

Source: SEB

Inflation targets and expectations

Central banks need to come to terms with these facts: (1) short-term real interest rates are rising as inflation falls, in an environment of lower economic activity, and (2) neutral real interest rates may return to low pre-pandemic levels, making monetary policy more restrictive the longer key rates stay at today's levels. Our forecasts of core inflation in the US and the euro area, for example, indicate that inflation targets will be achieved during our forecast period. This reduces the need for restrictive monetary policy, i.e. key rates above 2-2.5 per cent. The stress of higher long-term inflation due to structural changes – such as a more fragmented world economy and the energy transition – is being mitigated by the fact that the market's long-term inflation expectations have been surprisingly stable during the inflation shock. They have even been falling for the past two years.

Inflation expectations under control

Source: Macrobond, SEB

Despite dramatically rising inflation in recent years, inflation expectations have largely fallen. This is good news for future economic performance.

The Fed will slow the pace of quantitative tightening

The Fed is expected to slow the pace of reducing its balance sheet (quantitative tightening, QT). This decision is not primarily motivated by monetary policy but is related to the need for short-term liquidity in the financial system. When the Fed was buying assets, for example during the pandemic, there were three reasons: (1) to signal that the key rate would remain low for a long time, (2) to push down long-term yields and (3) to safeguard financial stability. QT has been less important as a monetary policy tool and has instead been motivated by a desire to normalise central bank balance sheets, thereby reducing the amount of excess liquidity. But financial stability considerations are important for the speed at which central banks move ahead with this process.

Energy: Lower but still elevated prices

Oil and especially European natural gas prices have fallen sharply since their peak in August 2022. In spite of this, demand for gas remains 15 per cent lower than normal in Europe, if we disregard temporary weather effects. One explanation is that energy is still expensive, with natural gas and electricity prices at some 60 and 110 per cent above their 2010-2019 averages, respectively. Europe's cost situation compared to the rest of the world has also worsened. European energy prices are based on relatively expensive gas. On top of that, CO_2 taxes have increased. Meanwhile, energy costs in many other countries are based on cheaper coal. For example, the US has far lower natural gas prices, and in most cases the mark-up due to environmental taxes is lower. In the short term, households find it hard to vary their energy consumption to any great extent, but the relative change in energy prices is something that affects businesses and helps keep demand below normal. Our gas and oil forecasts do not differ much from today's prices. The price of oil will be USD 85-90 per barrel in 2024-2025, and natural gas will remain stable at USD 40 per MWh.

Central bank policies determine long yields

Favourable inflation surprises last autumn and market expectations of earlier and faster interest rate cuts caused bond yields to fall sharply late last year. The decline since their October 2023 peak implies that the key rate cuts in our forecast have largely been discounted. With long-term yields already at low levels, continued downside potential is limited. A continued downturn would probably require the market to price in even further central bank rate cuts. Quantitative tightening (QT) is limiting downside potential as well. There is also uncertainty related to large budget deficits, especially in the US. But we do not believe that issuance volumes will be a driving factor over the next couple of years, since the US is expected to issue more short-term Treasury securities to ease pressure on longer maturities. The Fed is likely to reduce QT volumes earlier than the market has predicted. We believe that US 10-year Treasury yields will fall to around 4 per cent by the end of 2025. Their German equivalent will be slightly above 2 per cent.

The SEK turnaround has begun

The EUR/USD exchange rate bottomed out in September 2022 after nearly 15 years of a strong US dollar. Much of the euro's appreciation against the dollar since bottoming out occurred relatively soon after the turnaround, and during 2023 the euro's continued upward path was volatile. We expect a higher EUR/USD rate this coming year, driven by better risk appetite and wider interest rate spreads, as the Fed cuts its key rate at a faster pace than the ECB, but not necessarily first. In a broader foreign exchange (FX) market perspective, we expect economies – and currencies – that have performed weakly due to high interest rate sensitivity to undergo a reverse effect when key rates are cut in 2024 and 2025. This means that the JPY, NOK, NZD and AUD will be among the winners. The SEK should also benefit, although most of its appreciation probably already occurred in late 2023.

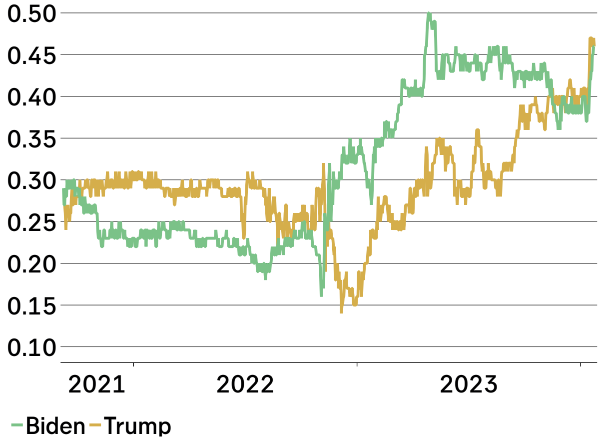
Support for SEK and NOK, short- and long-term

The Swedish krona experienced a sharp rebound late last year. This came after a poor start to 2023, when it weakened to around SEK 12 per euro, but by year-end it stood at SEK 11.10 per euro. We expect SEK appreciation to continue after a pause, driven by a soft landing in the US, upcoming key rate cuts and the improved risk appetite that such a scenario is expected to generate. We also believe that SEK support will continue into 2025, but more because key rate cuts should help Sweden's interest rate-sensitive economy grow faster – a reversal of what happened when rates were hiked rapidly and the economy slowed sharply. The same factors will benefit the Norwegian krone, which will also be supported by Norges Bank's later, slower pace of rate cuts.

The super-election year 2024

This year, geopolitical uncertainty will be spiced up by the fact that countries with a total of more than half the world's population – just over 4 billion – are going to the polls. To some extent, this figure may lead to exaggerated hopes for change, since only slightly more than half of these elections are regarded as free. The election in Taiwan a couple of weeks ago (which belongs to the free election category) has fuelled uncertainty about the island's relationship with China, since the more China-critical governing party DPP won. But topping this year's political agenda is undoubtedly the US presidential election in November. Most indications are that it will be a rematch between the incumbent president, Joe Biden, and former president Donald Trump. The US presidential election is important from several international perspectives, such as the Paris Agreement, NATO and support for Ukraine. In addition, there are elections in eight of the world 10 most populous nations, including India, Pakistan, Bangladesh, Indonesia, Mexico and Russia. In the EU, elections to the European Parliament will also take place. Although political changes often take time, the 2024 elections are occurring amidst geopolitical tensions and ongoing wars, while new rulebooks are being written on trade, environmental issues, global cooperation and conflict resolution. The year's many elections may thus play a bigger role than usual. In many countries, there is also increased support for nationalist parties, which may complicate international cooperation in the future.

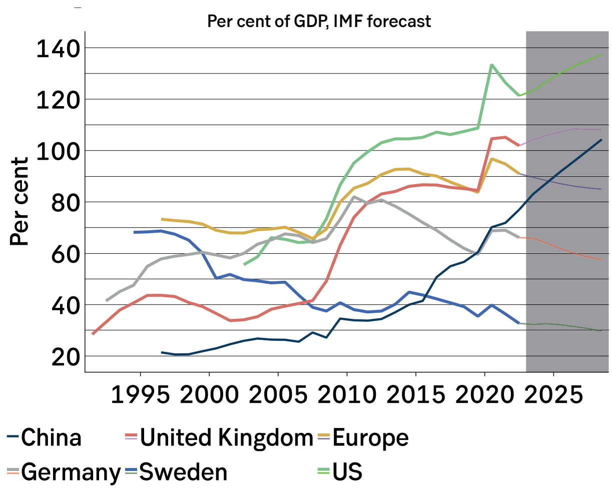
The 2024 presidential election



Source: PredictIt, Macrobond, SEB

There are many indications that the US presidential election will once again be a contest between Joe Biden and Donald Trump, with the latter more likely to win. This could have international repercussions.

High public sector debts in many countries



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

High public sector debts will constrain fiscal policy in many several countries, not least the United States. However, lower debt and falling inflation will open the way for more stimulus measures in Sweden.

Fiscal policy will focus on necessities

Despite an anaemic economy, fiscal policy will be largely neutral in the next couple of years, making it easier for central banks to cut interest rates. Already high public sector debt is limiting room for manoeuvre in many places and has occasionally been a source of concern in financial markets over the past six months. In many cases, fiscal policy regulations – some of which were on hold during the pandemic and the energy crisis – also impose limits on how expansionary budgets can be. Countries such as Sweden and Germany, which have relatively low debt and have experienced major declines in growth over the past year, could pursue a more active fiscal policy. In these cases, a combination of rules and political priorities has instead set limitations. Inflation is now falling and is thus disappearing as a constraining factor for fiscal policy in Sweden and elsewhere, but the scope for expanding subsidies or cutting taxes is also limited by the need to invest more in defence, security policy and the green transition due to the tense geopolitical situation and last year's record temperatures.

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