Investment Outlook

May 2020

SEB

Contents

Introduction

Restart after sudden halt?

- Exceptionally deep downturn is close to bottoming out.
- Unprecedented stimulus is supporting businesses, consumers and markets in hopes of a growth rebound.
- Collapse in oil prices after tensions among producers and sagging demand.
- Hoping for a greener economic recovery.

In the last issue of *Investment Outlook* (published in February 2020), our introduction closed with this forecast: "As usual, we can expect the unexpected during 2020, with occasional dramatic fluctuations in financial markets."

Our prediction proved more correct than we would have wished. The past few months have offered a rare degree of drama, unfortunately including much tragedy on the human level – against which all economic discussions pale. Yet our job is to try to understand and explain what is happening in economies and markets, make forecasts, manage assets and give appropriate advice. This is an unusually difficult task, as we face events and processes unparalleled in history, but it is thus also even more urgent.

We take what is happening very seriously. It is having – and will continue to have – a major impact on economic growth, the functioning of economies and financial market performance. But our forecasts indicate that economies are close to passing their low point, though an unusually deep one. This is clear from the current reopening of societies and economies, and the unprecedented stimulus that economic policy makers are enacting to support businesses, consumers and markets.

Although it will probably take several years before the economy reverts to its old growth trends, we still expect the rebound to begin during the next few quarters. This also gives us reason to be cautiously optimistic about the long-term stock market outlook, although the rally of recent weeks appears a bit too fast and frenzied. This has made equities expensive by historical standards, probably increasing the risk of setbacks if there are new disappointments.

But continued low interest rates and bond yields, as well as the prospect of several years of recovery-driven economic growth, suggest that higher share valuations may be acceptable in the future.

At present, we regard stock market downturns as potential buying opportunities.

In this May issue of *Investment Outlook*, as usual we are presenting some theme articles about current trends. We examine recent dramatic oil price developments due to plummeting demand and tensions between petroleum-producing countries.

We also follow up earlier theme articles on key developments in sustainable investments. This time we describe what is happening around renewable energy, a vital element of our shift towards a more sustainable society. We hope and trust that the stimulus measures that we expect will support the rebuilding of the economy after today's deep crisis will be green in nature, reinforcing our view that sustainable investments can both benefit society and generate future returns.

We do not feel it is necessary to point out once again that we can expect more drama, both in the news headlines and in financial markets. Many things will also be different once we emerge from the dark tunnel that is the coronavirus pandemic. We are more humble than usual about future challenges and are well prepared to adapt our investments and advice. But unprecedentedly aggressive stimulus measures and extremely low interest rates and bond yields – together with the stock market's ability to look past today's crisis towards future growth – nevertheless make us confident that there will be opportunities to generate long-term returns in our portfolios.

Wishing you enjoyable reading,

Kai Svensson, Acting Chief Investment Officer
Johan Hagbarth, Economist
Investment Strategy

Summary by asset class

In late February, when the coronavirus was severely affecting Italy, financial markets began to factor in a pandemic. In March, we experienced a generally tight liquidity situation of a kind we had not experienced since the 2008-2009 global financial crisis. Stock exchanges around the world plunged, but central banks and governments quickly came to the rescue. Unprecedented monetary policy stimulus was implemented via key interest rate cuts, quantitative easing and credit lines. Governments provided various forms of aid to the corporate sector.

We expect a deep recession this year and a relatively strong rebound next year. This forecast assumes that a gradual normalisation will occur as restrictions are lifted starting this spring and that the spread of the virus will fade. Fiscal and monetary policy stimulus will help fuel the recovery phase.

Earnings forecasts for listed companies have been revised sharply lower. On a global basis, earnings are now projected at 20 per cent lower than last year – a sizeable change compared to only a few months ago, when the forecast was a 10 per cent increase. Because of downgraded earnings forecasts and stock exchanges that have recovered half their decline, share price valuations based on 12-month forward earnings forecasts are somewhat higher than at the start of 2020. Corporate credits (bonds) fell sharply in March as the market began pricing in a greater risk of widespread defaults. But corporate credits began to regain ground after the US Federal Reserve announced plans to buy such securities. Other central banks are expected to follow suit. Aggressive policy responses have had a visible positive impact on risk assets overall.

As investors, we are in a situation of continuing great uncertainty about future developments. Earnings forecasts are still being adjusted lower and defaults are expected to climb sharply. Aggressive policy responses have lowered the risk premium on risk assets, thus maintaining valuations. In a relative perspective, we are somewhat more positive towards credit risk than equity risk, due to supportive bond purchases by central banks and capital injections by governments into the corporate sector, aimed at avoiding bankruptcies.

Global equities

- Due to lockdowns in many countries, corporate earnings will suffer widespread declines but recover in 2021.
- More than half the stock market decline has been recovered thanks to large stimulus measures, leading to high valuations based on projected 2021 earnings.
- Continued tug-of-war between large stimulus packages, low interest rates/yields and downgraded earnings forecasts.
- Small businesses are attractive from a valuation perspective.

Nordic equities

- Panic in markets = share sell-offs, often for limited periods.
- Dramatic cyclical weakening will lead to major downward revisions in earnings forecasts.
- The oil crisis affects many companies significantly; risk of disappointments if normalisation is delayed, but there are also winners in this crisis.
- After mixed Q1 reports, there is continued great uncertainty about Q2.
- There is a unique opportunity for a more sustainable restart, but will people heed the call for a "green new deal" to speed up recovery after the COVID-19 crisis?

Fixed income investments

- The "whatever it takes" strategy of central banks is slowing the upward trend in long-term government bond yields due to historically large budget deficits.
- Expected negative returns on government bonds are driving investors towards riskier fixed income investments.
- High yield bonds often perform as well as equities after a sharp decline, though at lower risk.

Alternative investments

- High volatility and short powerful market movements pose difficulties for trend-following hedge fund strategies.
- Macro fund managers with limited risk-taking have shown relatively stable performance amid turbulence.
- Extreme stock market volatility, along with net exposure, is hampering equity long/short funds.
- Diversification will limit volatility somewhat for multi-strategy hedge funds in 2020-2021.

Return expectations, %, next 12 months (SEK)

Equities	Return	Risk*
Advanced economies	7.1	18.3
Emerging markets (local currencies)	7.2	17.6
Sweden	7.3	18.0
Fixed income investments	**Return**	**Risk***
Government bonds	-0.8	1.5
Corporate bonds, investment grade (Europe/US 50/50, IG)	3.1	6.8
Corporate bonds, high yield (Europe/US 50/50, HY)	6.2	10.5
Emerging market debt (local currencies, EMD)	5.8	10.7
Alternative investments	**Return**	**Risk***
Hedge funds	3.5	7.0

* 24-month historical volatility

Source: SEB, forecasts May 2020

Risk exposure and allocation

Slight overweight in global equities, clear overweight in HY

During 2020 a balanced portfolio consisting of equities, fixed income and alternative investments showed negative returns, but more than half of the decline during March was recovered in April.

The rug was pulled out from under risk assets in March as investors realised the severity of COVID-19 and its impact on the global economy. Central banks, led by the US Federal Reserve (Fed), have helped sustain economies and markets via key interest rate cuts, massive quantitative easing and liquidity support measures. Governments have not held back either, but have enacted large fiscal stimulus programmes – in order to prop up businesses and thus reduce bankruptcies and job losses. Overall, these measures have helped risk assets such as equities and high yield (HY) bonds, but the economic damage left behind by the pandemic will undoubtedly take time to repair. The question investors are asking themselves is how fast economies can be restarted and revert to some kind of normality. Our forecast is a short but deep recession this year, followed by a robust recovery in 2021.

High valuations limit short-term stock market potential
In line with the dramatic overall downturn, global earnings forecasts have been adjusted sharply lower. At the start of 2020, markets expected a 10 per cent upturn. Now earnings are expected to decrease by 20 per cent this year, which is probably an underestimate. Enormous stimulus measures have eased the downturn for risk assets, so valuations have not fallen as much as corporate earnings. The forward-looking 12-month price/earnings (P/E) ratio is actually higher now than at the beginning of 2020. These high multiples will limit short-term stock market potential.

In terms of earnings, 2020 is a lost year. Markets have accepted this. Now what is important for companies is to minimise damage while consolidating and strengthening their market positions ahead of a recovery next year. Stimulus programmes will remain in place as long as needed and even longer. So the recovery, once it begins, should be robust and 2021 will likely be a year of strong earnings growth. This is one reason why, despite the current situation, our portfolios are slightly overweighted in global equities.

Central bank and government support benefiting HY
Central banks and governments have never before launched such powerful simultaneous crisis responses as today. Central banks are supporting bond prices via key rate cuts and direct market purchases. The Fed is buying bonds of all kinds, even in segments with lower credit-worthiness, via exchange-traded funds (ETFs). By means of generous fiscal stimulus measures, governments are doing everything in their power to keep businesses from failing. This has benefited bond holders – we are thus positive towards owning corporate credits, especially in segments with lower credit-worthiness (high yield, HY). Investors are still relatively well paid for lending to companies (credit spreads to government bonds remain relatively wide). In fact, during post-crisis recovery phases, HY bonds have often delivered returns that surpass stock market returns.

Highest valuations of future earnings since the dotcom (IT) bubble

Source: Bloomberg

The chart shows price/earnings ratios over the past seven years for the MSCI All Countries World Index in local currencies. P/E ratios have soared, which is explained by stock markets that have fallen less than downward adjustments in earnings forecasts, looking ahead one year.

Slight overweight in equities, expecting earnings growth
In March we upweighted global equities from underweighted to slightly overweighted, to take advantage of stock market weakness. Our reasoning was that the downturn would be temporary, though deep, and then the market would climb sharply with the help of stimulus measures. Despite high valuations, a slight overweight in equities is justified, since we expect the economy to gain strength in 2021. We also expect continued low interest rates and yields. We believe monetary stimulus will remain in place long after the global economy has recovered.

As for Swedish equities, in our portfolios we have increased the proportion of companies with stable revenues and balance sheets and with elements of cyclical exposure. We have retained the character of our international equity exposures, but have expanded them. We remain overweight in US growth companies of a structural nature. We are also overweight in Asian emerging market equities and the low-valuation small business segment. In fixed income, we are overweight in corporate credits, especially HY bonds, to take advantage of high underlying yields and massive central bank support. In addition, we hold a broad alternative investment portfolio that balances risk.

The fight against COVID-19 continues

There are positive signs that the spread of the coronavirus has stabilised in many countries. Governments in Europe, the US and Asia have thus begun planning to restart their economies by gradually easing the restrictions currently holding back economic growth around the world. Mass testing and new technology will be vital tools – and part of an "infrastructure" – to prevent new outbreaks and allow steps towards normalisation. This is an abbreviated version of an analysis in *Nordic Outlook*, published on May 6.

Despite improvements in the statistics, the battle is not yet won. The risk of new outbreaks is considered high and remains a cause for concern. Some countries perform health checks and follow the movements of individuals to keep track of where the risk of new outbreaks is biggest. Considering the enormous economic costs resulting from lockdowns, it is likely that such aggressive checking, tracking and other methods to combat the ongoing spread of the virus will continue, with the aim of returning as soon as possible to a somewhat more normal everyday life.

While awaiting a vaccine: Mass testing

Another tool that will help governments gradually reopen their economies without risking major reversals is mass testing of their citizens. Mass testing has definite potential to become an important part of enabling people to return to their workplaces. Quick, reliable tests already exist. Within the not too distant future, these tests may become a key element of efforts to restart economies.

Synchronisation important in manufacturing

The COVID-19 crisis has generated creativity and global competition in medicine and technology. Government exit plans will enable various parts of the economy to restart. For manufacturers, however, the timing of these plans will have to be fairly well synchronised. Otherwise some production might stop due to subcomponent shortages.

The first step is to restart production. After that, consumption will also have to resume. Households must feel it is safe to go to work and spend their money on goods and services.

The Chinese economy is estimated to have reached 90 per cent of normal status. This has occurred 2½ months after the lockdown in Wuhan, the city where the spread of the virus apparently began. However, China's economic recovery is now being adversely affected because the rest of the world has entered a deep recession.

The European Union and the United States are expected to gradually reopen their economies during May. Although it is uncertain how fast this will happen, there is already heavy pressure on governments to speed up the reopening process. This pressure can be expected to increase further as unemployment accelerates in most countries.

Pressure will also come from manufacturers, based on growing concerns about loss of competitive neutrality and about buy-out risks. Companies and countries that restart the fastest may enjoy big advantages and opportunities to gain market share at the expense of countries – and thus companies – that have decided to keep production closed for longer. Governments are likely to carefully monitor what others are doing, in order to ensure that their own manufacturers are not put at a competitive disadvantage. This dynamic – the competitive aspect and buy-out risk – will provide an incentive to launch the restarting process as fast as possible.

Closing is hard, opening even harder

It is encouraging that more and more governments are making plans for how their economies can return to a more normal situation. But if it was difficult to decide on locking down large parts of society, decisions to reopen them are even harder. Restarting too early may lead to another major virus outbreak, forcing the economy to shut down again. In that case, the potential for managing the new wave of disease would be even more limited.

Around the world, governments are now under pressure from citizens to reopen their economies – or at least plan for this. Most countries are well aware of the risks and will probably intervene quickly if developments move in the wrong direction. They could thus limit the size of a second wave as well as its economic consequences.

Testing capacity is already high and is growing continuously. Countries have also sharply expanded their health care capacity to take care of those who will become infected in a second wave. Herd immunity and vaccines are the paths forward to eliminate the COVID-19 problem in the long term. The experts disagree on which of these will arrive first. Most observers believe it will take one or two years before a vaccine can be ready for large-scale use.

Macro and other market drivers

Stimulus efforts bring light amid unaccustomed gloom

We live in uncertain times. A lot is happening that we have never lived through before. Most important, of course, are the tragic effects of the novel coronavirus and the great uncertainty surrounding its future spread. As a result of this we are also in uncharted waters regarding the economic consequences. Because of unprecedented shutdowns of entire societies so far – and their extremely rapid, far-reaching impact on the economy – we have neither economic theories nor similar historical experiences to rely on when predicting the future.

But although this monumental uncertainty makes numerical forecasts outdated as soon as they are published, there are some things we actually know and can use in creating scenarios about the future. The world economy is undergoing the fastest, deepest downturn of our era. Global growth is plummeting and unemployment is soaring. The responses being mounted, mainly by governments and central banks, are completely unparalleled in history.

How all this will unfold naturally depends very much on how the virus continues to spread and what the reactions are. We are working with a main economic scenario and two alternative outcomes, one brighter and one gloomier. Below we describe our main scenario, which assumes that European countries and the US will soon gradually reopen and that the world will eventually be better equipped to face any virus setbacks, so that the economic consequences are manageable.

Without a doubt, the sudden halt that has affected the economy will eliminate production resources. Many industries are paralysed. Businesses and large parts of economic sectors will close permanently. Many of the stimulus measures that have been enacted are aimed at limiting these effects and helping businesses survive the crisis. During lockdown periods these measures do not help much, but assuming that countries can reopen at the pace that political leaders are discussing, we see prospects for manufacturers in particular to recover without excessive casualties. The problem is that there must also be demand for the economy to grow. Unemployment is skyrocketing, with fresh statistics pointing to a jobless rate of about 15 per cent in the US, compared to less than 4 per cent just a few months ago. The picture is similar in Europe. As for Sweden, we expect unemployment to peak at around 12 per cent. Our conclusion is that even if growth rebounds in the second half of 2020 as economies reopen, we will have to live with forces that hold back economic growth for the next couple of years.

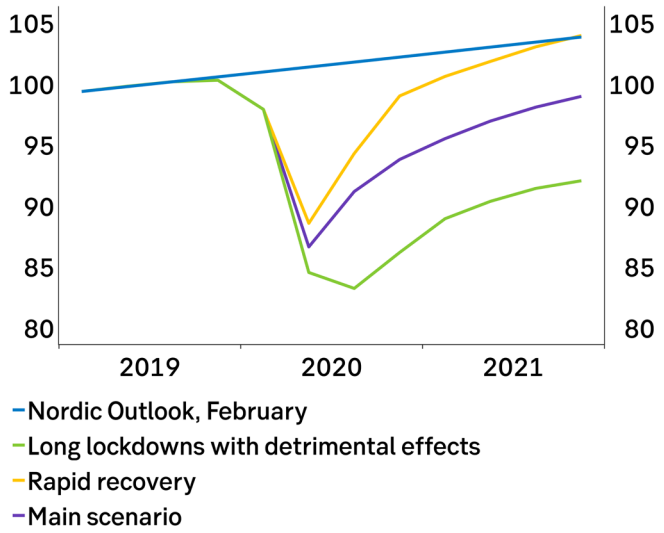
But these restraints should not be overstated either. After the recent plunge in global GDP, we expect a major rebound in growth, albeit from low levels. As mentioned above, large-scale stimulus measures will help. We estimate that government and central bank support totals more than 17 trillion US dollars so far – a totally incomprehensible figure, perhaps more easily understood as equivalent to about 20 per cent of global GDP. To date, these stimulus packages have primarily been aimed at crisis management: saving businesses, injecting liquidity into the financial system and helping hold down interest rates and thus funding costs. Once the economy hopefully leaves the acute crisis phase, the focus of attention will shift towards starting to rebuild the economy, both in terms of production and demand. Here, we expect continued big stimulus measures, especially from governments.

GDP forecasts, year-on-year percentage growth

Market	2019	2020	2021	Comments
United States	2.3	-6.5	5.6	Aggressive crisis responses are making holes in the budget.
Japan	0.7	-5.3	3.0	An active central bank is trying to soften the impact.
Germany	0.6	-7.7	5.8	Stimulus and strong finances are easing the slump.
China	6.1	2.0	9.0	First in, first out – is there a risk of new outbreaks?
United Kingdom	1.4	-11.6	4.3	Brexit and widespread infection will deepen the downturn.
Euro area	1.2	-9.6	6.2	A deep recession will put pressure on cooperation efforts.
Sweden	1.1	-6.5	5.0	Smaller GDP decline, due to gentler lockdown strategy.
Baltic countries	3.6	-9.0	5.9	Tough economic situation, but less severe than in 2009.
OECD	1.7	-7.0	5.1	Lockdowns are being met by extreme policy responses.
Emerging markets	4.1	-0.6	6.1	The biggest GDP decline since the Second World War.
World, PPP*	3.0	-3.3	5.7	A historic economic halt, despite record stimulus packages.

Source: OECD, IMF, SEB. *Purchasing power parities.

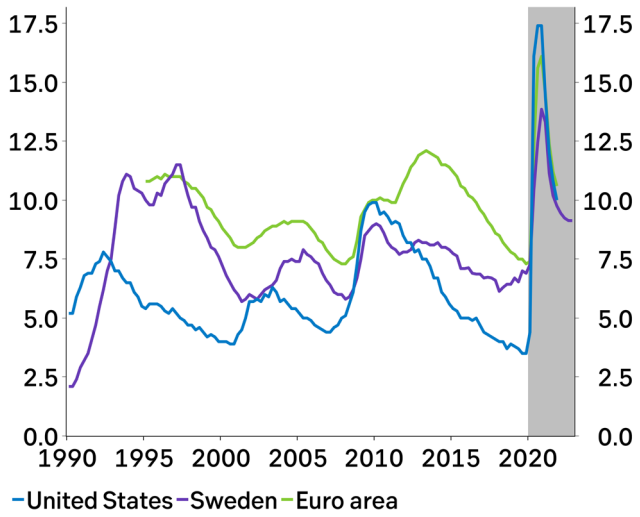
Rapid nosedive, sluggish recovery



Source: SEB

In our main scenario, we expect the economy to accelerate again at a healthy pace, but because of the deep decline it will take several years before the economy has regained lost ground. We believe that the global economy, measured as GDP at the end of 2021, will still be some 5 percentage points lower than it would have been if it had followed the trend we predicted before the crisis.

Record-fast upturn in unemployment is worrisome



Source: Macrobond

Unemployment is rapidly increasing to levels not seen since the 1930s depression. This will have a major impact, especially on demand. But most of the increase consists of temporary actions, such as furloughs. If the economy restarts again as expected, unemployment should then fall quickly, but there is a major risk that it will get worse before it gets better.

We expect that growth will restart in the second quarter and that we will see a fairly rapid recovery with solid growth percentages next year, but given the current halt, it is still likely to take several years before the economy is back to its previous trend. We expect global GDP to be around 5 percent lower by the end of next year than predicted in the last issue of *Investment Outlook* (published in February 2020).

Given all the policy responses so far – with governments borrowing to cover stimulus measures and central banks "printing" money to cover bond purchases – two important questions arise: How should all this be financed? And won't it lead to rapidly rising inflation?

As for financing, we believe it will not be a problem, at least in the near future. The answer to the question about where the money will come from can be found in the second question – big stimulus measures, that is, increases in government debt – are financed when central banks buy bonds issued by governments and others. This is like letting central banks print new money. In theory, they can do this in an unlimited amount. Higher government debt becomes a problem in two cases; if interest rates rise, or if lenders demand repayment of the debts. But interest rates are of course largely controlled by central banks, and they are behind the loans (bonds), so none of these risks will necessarily be a problem in the near future.

As for inflation, short-term forces will keep it down. Weaker demand and higher unemployment will slow pay and price hikes, while falling energy prices will push inflation down towards zero in the near future. In a few years inflation is likely to climb again, but we believe the structural forces that previously kept inflation down will still be in play, especially globalisation and digitisation/automation. The latter trend is likely to intensify, since at this writing many of us are learning that more of everyday life can be managed without travel, business meetings and other activities.

Finally, if inflation should nonetheless show signs of accelerating, central banks can quickly withdraw liquidity from the market and thus hold back that trend. So neither debt nor inflation appears to be a problem in the short or medium term, but there will be consequences that must be dealt with – especially the allocation of roles between central banks and political leaders, as the potential influence of the former increases.

To summarise, the economy is undoubtedly in a dark tunnel, with major problems that need to be addressed and severe effects on growth. But there are lights in the tunnel, in the form of stimulus measures and the reopening of societies and economies. This means we still expect a gradual return to more normal economic conditions over the next couple of years. One possible, and in our opinion hopeful, effect of what is happening may be that some of the investments needed to boost the economy can be of a clearly sustainable nature – a chance to turn something that is negative in the short term into something positive in the long term.

Valuations

The forecast related to 12-month forward-looking price/earnings (P/E) ratios is at historically high levels. This is because corporate earnings for the next year have been adjusted downward by more than stock markets have fallen. If we take into account low interest rates and bond yields, adding that the economic recovery is expected to be robust during 2021, these valuations may absolutely be justified, but the short-term valuation upside is limited.

At the moment, corporate bonds are more attractively valued than equities. Factoring in future defaults and projected asset recovery levels, the yields offered for both investment grade (IG) and high yield (HY) bonds are relatively appealing, but this presupposes that our forecast of an economic recovery during next year materialises to some extent.

Whereas the stock market is driven by earnings growth, the credit market is driven by the repayment capacity of companies, which does not make equally strict demands on the growth factor. Stabilisation of the credit market and economic conditions may be enough to ensure that bond holders will receive their coupon payments and thus their returns. This may be an advantage if the recovery follows a flatter curve than we are now forecasting.

Another argument for investing in credits as opposed to equities is the aggressive support measures being enacted in order to help businesses survive the crisis – which will probably decrease the risk of credit losses – plus the fact that a number of central banks, not least the US Federal Reserve, have announced that they will now buy corporate bonds (including some HY bonds) for the purpose of supporting the market.

Risk appetite and positioning

Short-term risk appetite indicators reached extremely high levels during February. Conversely, risk appetite was essentially zero during late March. Investors' willingness to take risks has rebounded, but asset managers are generally more sceptical than before. This is evident from the high percentage of cash holdings in their portfolios and their more defensive allocation among asset classes. Defensive sectors and structurally growing companies are favoured over cyclical sectors. Companies with strong balance sheets are favoured over highly leveraged companies, and so on.

We use positioning and risk appetite among the investor community as counter-indicators when we assess how much risk we should take in our portfolios. At present, defensive positioning and low risk appetite are contributing to our slight overweight in risk assets.

Fixed income investments

Potential for continued recovery in corporate bonds

The "whatever it takes" strategy of central banks, with their various stimulus packages, is moderating tendencies towards higher long-term yields in light of historically large budget deficits. Given the risk of negative expected returns on government bonds, investors must seek out riskier fixed income investments to generate returns.

For those prepared to increase their risk in the fixed income segment, corporate bonds with a higher risk could be a good first step. They often perform as well as equities after a sharp downturn and do so at a lower risk. It may therefore be a good time to buy, especially if market stress increases a bit again.

Government bonds (excl emerging markets)

During the coronavirus crisis, the US Federal Reserve (Fed) has been very proactive, quickly taking forceful measures. The Fed lowered its key interest rate to near zero and launched wide-ranging, unlimited asset purchases, expanding them to include more than just government bonds. It also initiated an extensive lending programme aimed at small businesses and provided dollar liquidity both in the US and abroad.

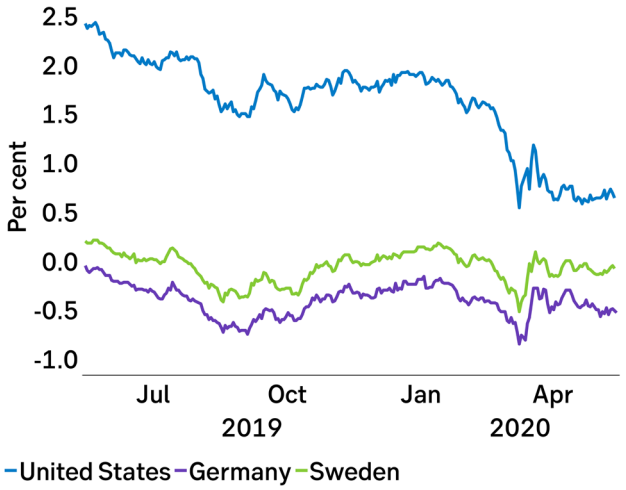
For Europe, interest rates are a relatively useless weapon given already record-low rates. Instead, balance sheets will continue to be employed, with the European Central Bank (ECB) having increased its asset purchases primarily through the bond market. Further rate cuts cannot be ruled out, but we believe the ECB has strong reasons to avoid them. Banks in Germany and Italy, for example, are already squeezed, and at present it would be extremely unfortunate if the situation were to deteriorate in a way that would seriously restrict their lending capacity.

Forecasts for 10-year government bond yields

Market	May 18, 2020	Jun 2020	Dec 2020	Dec 2021
United States	0.65	0.70	0.90	1.20
Germany	-0.52	-0.40	-0.40	-0.10
Sweden	-0.08	0.15	0.15	0.35

Source: SEB, market data May 2020

Tug-of war between bond supply and demand



Source: Macrobond

When risk appetite decreases, money often flows to safer fixed income securities, yet despite the stock market collapse in March, Swedish and German yields rose. After new support measures from the world's central banks, yields have fallen again. A combination of better economic growth and increased bond supply will lead to somewhat higher yields in 2021, but because of central bank bond purchases, yields will remain at historically low levels.

Sweden's Riksbank has announced an expanded asset purchase programme that includes mortgage-backed securities plus corporate and municipal bonds along with government bonds. Meanwhile, the central bank has kept its repo rate at 0.

Although central banks could argue for rate cuts given the coronavirus crisis, there is little desire to cut rates to below zero. Nor is it likely that CBs will increase rates over the next few years, and there will be acceptance if they exceed inflation targets. This suggests that short-term government bond yields will remain low for a while.

The trend of long-term government bond yields is harder to predict. In the near term, news about the spread of the coronavirus and changes in risk appetite will determine the direction. The tug-of-war between bond supply and demand will determine future long-term yields. Central banks will need to fund their enormous stimulus measures by issuing more bonds, but at the same time will be prepared to buy more if interest rates rise in a way that jeopardises economic growth. In our view, the risk of production disruptions and reduced global trade will lead to somewhat higher inflation, driving long-term government bond yields higher, but we consider it unlikely that inflation will skyrocket.

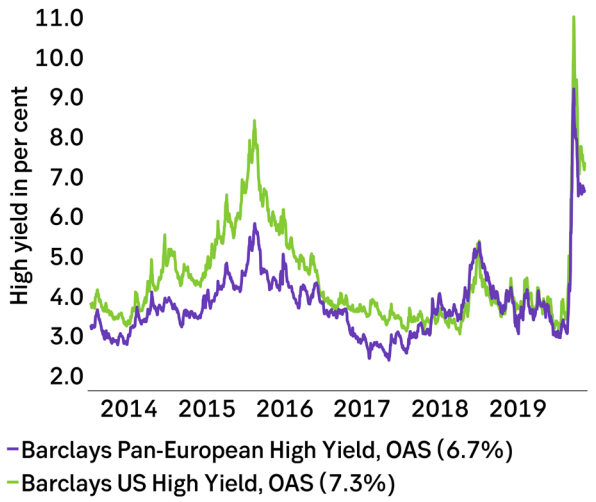
Corporate bonds – investment grade (IG) and high yield (HY)

During the coronavirus crisis, we have seen falling prices for corporate bonds, especially those with higher risk – high yield (HY). A bond is a kind of loan. In an economic downturn, there is a greater risk that companies will have financial problems and in the worst case go bankrupt. Because of this uncertainty, investors want to be paid more in the form of a higher yield in order to lend to these companies.

Another reason for falling prices is poor liquidity. Pricing and trading in the corporate bond market do not work the same way as in the stock market. Sellers and buyers obviously agree at some level, but there is often no order depth, and even under normal market conditions the price may vary among different market players. When the market is stressed, like now, these variations become even greater, and for some bonds there are at times few or no buyers.

The corporate bond market was hit on another front, as oil prices plummeted due to the price war between Saudi Arabia and Russia. The US is a major oil producer, and banks lend money to oil companies. Internationally, 10-15 per cent of the corporate bond market is exposed to the commodities sector. The bonds primarily affected are issued by oil-related companies, but this is also spilling over into other segments of the corporate bond market. The price war has benefited investors that have taken a sustainable approach in their exposure to corporate bonds. Since most sustainable funds exclude oil-related companies in their investments, this has given these funds a relative advantage over traditional funds, which typically include such companies.

Historically attractive corporate bond yields



Source: Bloomberg/ Macrobond

Credit spreads, which are supposed to offset the higher risk of corporate bonds compared to government bonds, widened in March. Spreads have narrowed but are still wide. If our main scenario holds, there is good reason to believe corporate bond investments can generate good returns over a 12-month horizon.

Credit spreads (the difference between the yield companies must pay and the yield on government bonds) are far above the historical average, especially for HY bonds. This is justified by the increased risk of credit events – that is, of companies not being able to repay bond holders. More normal credit spreads between US high yield and government bonds are 3-4 percentage points, while at its widest this spring the spread was around 10 percentage points. It is currently at 7-8 percentage points.

When investors make their return forecast for corporate bonds, they need to adjust for expected credit losses. During the global financial crisis just over a decade ago, 13 per cent of US high yield bonds were affected by credit events. Market forecasts today are around 10 per cent. For credit events in high yield bonds, it has historically been possible to recover an average of 50 per cent of the bond's value in the agreement following a credit event. On the other hand, we expect that credit spreads should narrow going forward once the economy stabilises. It is enough for these spreads to shrink halfway towards historical normal levels for higher bond prices to more than offset credit losses.

Reduced concerns about the spread of the coronavirus and increased support from central banks (mainly the Fed) have caused corporate bonds to rise in value again in recent weeks. However, considering the yields that investors earn on HY bonds, they are still far above the historical average. These bonds today generate a good running yield, around 6-7 per cent. For investors who believe we are headed towards normalisation, it is probably a good time to buy, although there are risks. Great uncertainty still exists, and there could be more negative news about the spread of the virus and further economic consequences.

For investors who want to take a lower risk, due to the March downturn, future returns on lower-risk corporate bonds (investment grade or IG) are also higher than before the coronavirus crisis, but with lower return potential than for HY bonds. We foresee that these companies will benefit from expanded central bank stimulus measures; the companies are often large and stable and should handle the effects of the economic downturn relatively well.

Emerging market bonds

Despite interest rate cuts in a number of emerging market (EM) countries this past year, in part due to the coronavirus outbreak, yields are still far higher than in developed markets, allowing continued good running yields. Furthermore, weaker global growth forecasts could lead to further key rate cuts in a number of EM countries, which would have a positive impact on underlying bond prices. Meanwhile, EM currencies have weakened due to the prevailing uncertainty. Slower global growth, a strong USD and record-low oil prices are all factors that have had a negative impact on economic conditions in EM countries, indirectly weakeneing their currencies. A recovery for some of these factors would have a positive impact on these currencies, which could provide support for this type of investment in the local currency as well.

Global equities

Weaker earnings prospects vs robust policy response

Not surprisingly, prices for various kinds of corporate risk have risen since the dramatic stock market slump earlier this spring. Stimulus packages and prospects of reopening economies justify lower risk premiums. Share prices are now approaching earlier peaks, indicating that the market is already discounting more normal earnings levels. We share this long-term view but see risks of disappointment along the way.

The outbreak of the coronavirus pandemic caused one of the biggest stock market downturns in living memory. Large-scale lockdowns of countries and economies will naturally lead to a broad decline in corporate earnings. This also happened in a situation where equities had been trading at valuations on a par with previous peaks (except for the millennium bubble) The subsequent declines were in the 30-35 per cent range, which is around the historical average for bear markets – defined as periods when the stock market falls more than 20 per cent.

There are also good reasons why stock markets then relatively quickly rallied. A flattening of COVID-19 infection curves shifted the political conversation from the scale of necessary lockdowns to how, and at what speed, reopening should occur. Combined with unprecedented stimulus packages, which at this writing are still being increased, that gives investors reason to expect that the earnings collapse now under way will be replaced within a reasonable period of time by earnings increases. However, it seems a bit optimistic to expect the fastest economic rebound in modern times, even though more than half of the decline has been recovered, as measured by America's S&P 500 index.

Broad stock market downturn when everyone is affected

The downturn also differed in other ways from previous stock market crashes. Since this crash was triggered by a non-economic factor with a wide-ranging impact on the entire economy, it affected every market segment in a fairly similar way. At the sectoral level, energy stands out as having by far the worst declines, driven by the oil market drama. IT and pharmaceuticals/biotechnology have emerged from the downturn relatively unscathed, thanks to strong balance sheets and stable cash flows.

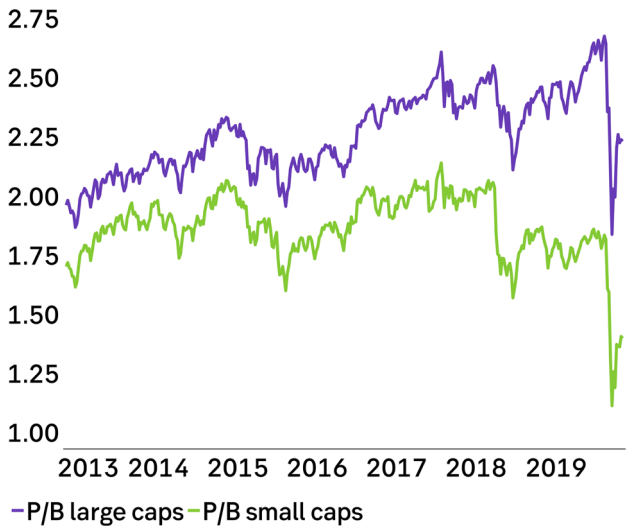
Otherwise, the differences are fairly small, with cyclical sectors on the weaker side. However, one exception is small cap companies, which have fallen more than the overall market; that is usually the case in recessions. But this time around, the discrepancy in performance between large and small caps is greater than usual. This can be explained in part by higher leverage among small caps than large caps and by far higher small cap leverage than in previous recessions. Most small cap borrowings are also categorised as high yield (HY), which is not the case for large caps. Wider credit spreads (the difference between corporate and government bond yields) have thus had negative consequences for small caps, which are forced to refinance at much higher rates, in an extremely precarious situation.

There is thus a strong correlation between HY bonds and small cap share prices. Fortunately, governments are providing targeted support measures for small caps, since they employ a large percentage of the population. Central banks are also supplying aid through direct bond purchases, pushing down yields. Valuations have fallen sharply for small caps, one of the few market segments that have discounted a recession, which means there is great upward potential during a normalisation process.

Earnings forecasts may fall further

Judging how reasonable today's share prices are based on the usual factors – earnings growth and valuations – is more difficult due to great uncertainty about future economic

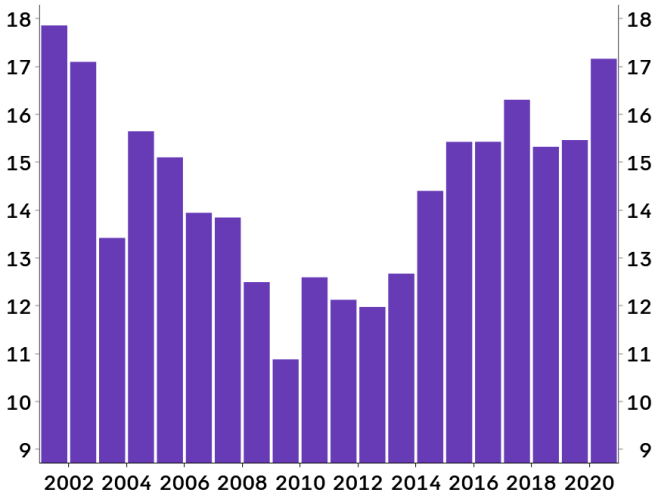
Large caps normally valued, small caps valued at a big discount



Source: Bloomberg

The chart shows the price-to-book ratio (share price/ book value per share) for both large and small cap companies based on MSCI's large and small cap world indices.

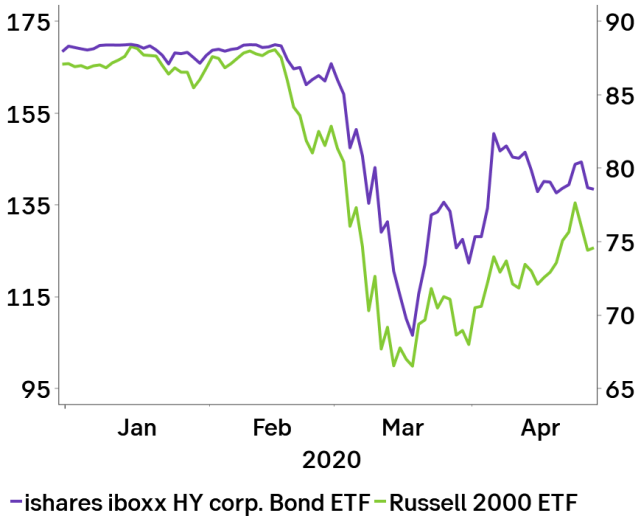
Historically high valuations of next year's earnings forecasts



Source: Macrobond

The bar chart shows P/E ratios for next year's earnings based on share prices on April 30 and an earnings forecast for the next 12 months.

High correlation between US small caps and HY bonds



Source: Bloomberg

The chart shows the trend for a US small cap exchange-traded fund (Russell 2000 ETF) and a US high yield bond ETF (ishares iboxx HY Corp Bond ETF).

developments. Since everyone is assuming a sharp drop in earnings this year, followed by a recovery in 2021, the question naturally is what earnings should be used in calculations and what multiples are reasonable.

Forecasts of the MSCI World index of equities suggest that global earnings will fall this year by nearly 20 per cent, with a risk of further downward revisions. For next year, consensus forecasts indicate a fairly sharp earnings upturn; analysts expect earnings for S&P 500 companies in 2021 to be somewhat higher than in 2019. This seems a bit overly optimistic, since growth forecasts point to a clearly lower average in 2021. Also remember that 2019 was a year when everyone had a job and companies were operating at full speed.

The reason for these high levels is probably that the focus has been on downward revisions for this year; meanwhile there is further room for earnings forecasts to fall. Earnings will affect most sectors but to varying degrees. Some sectors such as consumer staples and "do it yourself" (building material retailers and the like) as well as companies associated with staying at home such as Netflix and Amazon have seen increased demand. Banks, in contrast, have already made large provisions for future credit losses in the first quarter, which affects earnings to a great extent. For example, JP Morgan Chase set aside provisions of nearly USD 7 billion in the first quarter. We have not yet seen major earnings declines from manufacturers and consumer goods companies, but we should be prepared that next quarter will be one of the worst in history in terms of earnings and cash flow. Investors should know and expect this by now.

2020 a lost year

It is hardly meaningful to study valuation metrics such as the price/earnings (P/E) ratio based on current-year earnings forecasts. If we instead use forecasts for next year, the P/E ratio based on today's share prices is 18. The above bar chart shows share prices in April each year using a 12-month forward-looking earnings forecast for every year since 2002.

The results are slightly depressing, although today's exceptionally uncertain earnings forecasts with their downside risk give the market its highest valuations since the millennium (IT or dotcom) bubble. It may be hard to understand that investors accept such valuations and that there are buyers at these price levels. Such investors probably expect earnings to climb for a longer period after their downturn, so they are not just counting next year's earnings increases, as most valuation models do. Another explanation may be that investors feel justified in accepting higher-than-historical valuations because interest rates and bond yields are lower. This is reasonable in itself, but high valuations will probably make the market more sensitive to any bad news. Interest rates and yields will be low for a long while, providing support for higher stock market valuations. Combining these factors, today's historically high valuations may very well be justified, thus creating a new valuation standard.

Low interest rates prop up the stock market

For those who believe in a faster-than-expected recovery in growth and earnings, the greatest potential is in equities. But SEB's main scenario also strongly suggests that the market may be prepared to discount earnings further in the future (and thus accept higher valuations than in traditional valuation models), so share prices may rise in this otherwise bleak environment. However, because of the rapid upturn, further weak economic statistics may create new uncertainty and new stock market dips over the next few months, a common pattern in major downturns. However, the TINA – There Is No Alternative – argument suggests that any decline will quickly attract buyers who lack alternatives. If this growth scenario holds, the stock market has probably already bottomed out.

Nordic equities

Crisis struck quickly; recovery will take time

Over the past three months, the stock market's performance has been dramatic. Seemingly boundless optimism in mid-February – despite growing awareness of what consequences COVID-19 would have in China – quickly turned into panic and the fastest stock market nosedive in modern times. The market started recovering during the last week of March, and April was the best month for Nordic equities in five years. Exceptionally robust monetary and fiscal measures are behind this improved stock market sentiment, along with indications that the most pessimistic pandemic scenarios that were feared earlier will apparently not materialise. However, there is still great uncertainty. An immediate economic recovery is totally improbable, but after a wave of sharply downgraded earnings forecasts, expectations are already more reasonable.

Changing behaviour patterns and deteriorating international relations threaten to slow the economic recovery. We see a clear risk of new disappointments about the strength of the recovery later this year in various companies and sectors where equities have already recovered most of their lost ground. A crisis is rarely only negative – it often also creates opportunities – and the coronavirus crisis has presented a rare chance to rebuild society in a more sustainable way. But will calls for a green new deal be heeded? This will be an important issue for equity investors to follow.

Panic and turmoil often create buying opportunities

In mid-February, the consensus view in financial markets was still that coronavirus was primarily a problem for China and indirectly for companies that operate or buy products from there. That view changed completely, and in just three weeks we went from hopes of a modest improvement in manufacturing activity in 2020 – due to a ceasefire in the trade war between the US and China – straight into the fastest recession ever. We are now experiencing the worst economic slump in modern times. In the US alone, 36 million jobs have disappeared so far during the crisis, which can be compared to the single worst week previously in March 2009, when 665,000 new unemployment benefit claims were filed. This crash has been exceptionally dramatic.

Fears both about people's health and the economy created panic in financial markets. Trading in many corporate bonds temporarily ground to a halt – an unpleasant reminder of the situation in the autumn of 2008. Fear gauges such as the VIX index went through the roof, hitting their highest level in the US since 2008 and setting new records in Europe.

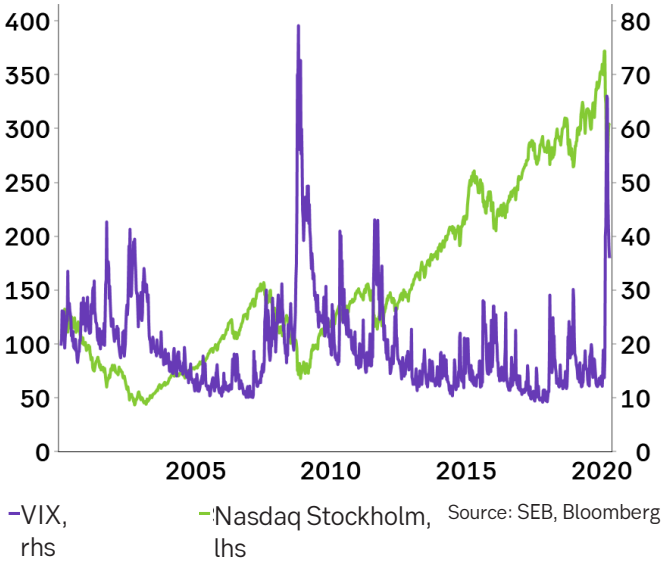
By definition, it is very difficult to summon enough courage to buck the trend and buy when market turmoil is at its greatest. Nor do we know until afterwards when the situation is actually worst. Prices often fall extremely fast in this panic phase, which is why buying too soon can be very costly. However, history shows that in these situations good buying opportunities usually arise, especially in the very short term, but often over a six- or twelve-month horizon as well. The table below shows returns since the turn of the millennium over a one-, three, six- or twelve-month horizon for an investment on the Nasdaq Stockholm stock exchange at the end of the week when fear, as measured by the VIX index, peaked. So far we can only say that this time around too, it has been especially profitable to buy when the VIX index peaks, at least in a one-month horizon. Historically, the recovery usually last longer than just one month, and the next two, five and eleven months are usually good. Meanwhile the stock market recovery has been unusually rapid this time, while there are strong indications that the economic recovery will be more protracted.

	Return, SBX in per cent			
Date Y-M-D VIX peak	1 mo	3 mo	6 mo	12 mo
2001-09-21	13	27	28	-23
2002-07-26	11	0	0	17
2007-08-17	1	-6	-19	-22
2008-10-24	-5	2	33	61
2010-05-21	10	6	16	27
2011-08-19	5	6	25	26
2015-08-28	-5	3	-6	2
2018-02-09	6	11	13	8
2018-12-28	7	13	19	33
2020-03-20	15			

Source: SEB, Bloomberg

The table shows returns over a 1-, 3-, 6- and 12-month horizon for the Nasdaq Stockholm exchange from peaks in the VIX index, an established fear gauge in financial markets.

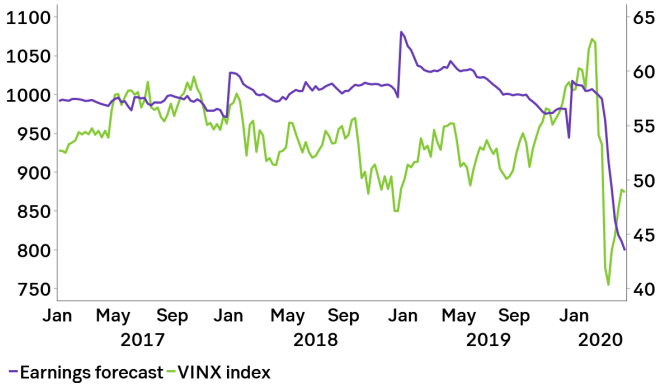
Times of turmoil bring bargains in equities, but usually only for a short while



Source: SEB, Bloomberg

The chart shows the re-indexed trend for the Nasdaq Stockholm exchange – the SBX index – with an initial value of 100 in January 2000, as well as America's VIX index. The VIX index is based on the implicit volatility of S&P 500 index options and is used to gauge investor worries. The higher the index, the greater the nervousness.

The stock market is defying sharply downgraded earnings forecasts for 2020



Source: Bloomberg

The chart shows the VINX 30 index of the 30 largest Nordic listed companies and indexed earnings forecasts for the same companies. Earnings forecasts have been revised dramatically downward due to COVID-19, but investors are forward-looking and the VINX 30 has already recovered a large proportion of its losses.

Lower earnings forecasts due to dramatic recession

The economic downturn we are now experiencing has no historical parallels, at least during peacetime. In particular, the almost perfectly synchronised plunge in economic activity across the world is unique. Despite massive economic stimulus measures (which are also uniquely large and simultaneous, but unfortunately often not well-coordinated), global GDP forecasts for 2020 have been revised sharply lower.

Meanwhile the consensus earnings forecast for the biggest Nordic companies in 2020 has been revised downward by 27 per cent since mid-February. Because the stock market has slumped by 15 per cent at this writing, earnings multiples have once again expanded. However, it is not at all unreasonable for the stock market to decline less than earnings forecasts for this year, since only a very small part of a company's valuation is normally explained by projected earnings for a single year. Moreover, at least the most stable listed companies – whose earnings are not at all affected or which may even benefit from the current crisis – might show higher valuations today than at the start of the year due to lower risk-free interest rates.

However, increased uncertainty, both in the short term and over the next few years, should more than offset the effect of lower risk-free interest on return requirements for the market in general. We are somewhat perplexed that share prices for a number of large manufacturers and oil companies have recovered virtually all their losses since February, even though their operations will be hit tremendously hard in the short term and their outlook for at least the coming year is worse or more doubtful than three months ago. There is thus a clear risk of reversals after the recent recovery in parts of the stock market.

While some portions of the economy will probably manage to rebound quickly once restrictions are lifted and general concern about the virus eases, there are also significant economy sectors in which the recovery may take a very long time. In some cases, the change may even be permanent. For example, there is a clear risk that subcontractors to the oil industry and civil aircraft manufacturers can expect many years of poor demand. The migration of retail sales to online merchants has picked up tremendous momentum due to the coronavirus crisis. Some of this change will be permanent, with consequences for both bricks-and-mortar retailers and the commercial real estate sector. There is also speculation about a permanent increase in working from home and increased use of digital tools instead of physical meetings. If these forecasts of behaviour changes prove correct, they will have a negative impact on demand for office space and travel. The winners will be various IT companies, which unfortunately are largely listed in the US and have little weight in Nordic stock markets.

Mixed news from corporate earnings reports

The first quarter 2020 report period was received relatively well by investors. Many companies have acted swiftly to address deteriorating market conditions. Although COVID-19 hit China very hard as early as February, it is clear that the first quarter until mid-March was relatively good for many Nordic companies. The improvement in international manufacturing activity that was discernible in the fourth quarter of 2019 for many companies further accelerated in early 2020. Unfortunately, things then came to a complete standstill around mid-March, and we know that the second quarter will be catastrophic in many cases.

Companies consistently painted a bleak picture of late March and the start of the second quarter, to the extent they commented at all on the second quarter. However, analysts' earnings forecasts had generally already been adjusted for this before the reports were published. For SEB's analysts, average earnings forecasts for industrial companies were

revised upward after they published their reports (although remaining much lower than they were in February). A number of companies also impressed analysts by adjusting their costs incredibly quickly to lower demand. In a few cases, companies reported virtually unchanged operating margins compared to last year, despite a double-digit decrease in sales revenue.

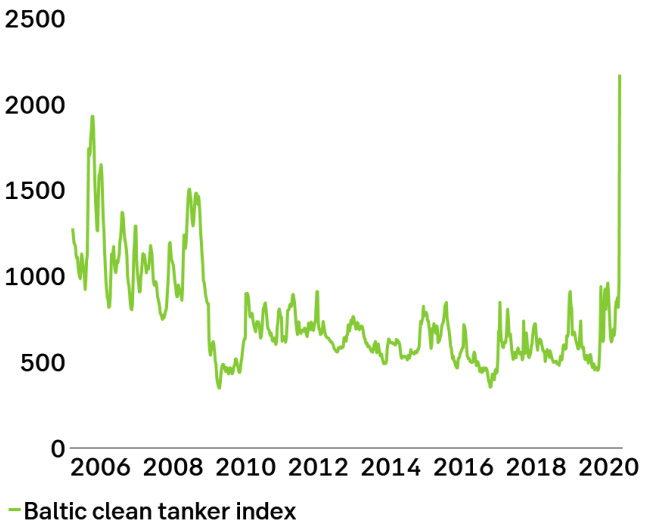
The major Swedish and Finnish banks also reported generally better earnings than expected due to lower credit losses than forecast, but in Norway and Denmark the situation was the reverse. However, these deviations may largely be a matter of how they timed their loss recognition than of actual differences compared to analyst forecasts. We will have a better picture only after second quarter earnings reports.

Banking sector weighed down by dividend uncertainty
Bank share prices, which bottomed out around March 20, did not recover as strongly as those of industrials. This was despite the fact that banks have more exposure to their domestic economy; Swedish banks should thus benefit from the less economically disruptive steps taken in Sweden to prevent the spread of COVID-19.

One partial explanation for the weak performance of bank shares is probably increased worries about weak financial institutions, above all in southern Europe, which are also rubbing off on Nordic equities. The European banking index was at its lowest level since 1988 as recently as mid-April.

Another explanation may be connected to dividends. As with most industrials, proposed bank dividends have been delayed, lowered or cancelled. It is politically sensitive to distribute money to shareholders when companies and banks are benefiting from various stimulus measures aimed at mitigating the economic downturn. In the long term, of course, dividends are absolutely critical to share valuations for both industrials and banks, but in the short term dividend yield is far more important for bank shares than for industrial shares in the Nordic stock market. The dividend yield for 2018, which was paid in 2019, was 3.8 per cent for Nordic industrials compared to 6.9 per cent for banks. Increased uncertainty about dividends in the near term has therefore probably had a greater effect on bank shares than on the rest of the stock market.

Record-high tanker freight rates due to the oil crisis



Source: Bloomberg

The chart shows the freight rate index for product tankers. The extreme oil market trend in 2020 has led to huge demand for tankers as floating storage units for both crude oil and refined oil products.

Dramatic deterioration in the oil market
While the stock market has provided a dramatic roller coaster ride in recent months, it has been a breeze compared to the oil market, especially in North America – where the price of a barrel of oil for May delivery was, at its lowest, minus 38 US dollars a barrel. In other words, anyone willing to receive this oil was paid to do so and could then sell the same oil for about 10 dollars a barrel just one month later, provided storage space could be arranged.

The extreme price differential between oil for delivery soon and oil for delivery several months later has also been unusually wide elsewhere in the world, although the North American situation was exceptional. The effects of this have spread to refined oil products. A refinery or oil trader that takes delivery of crude oil today and then waits to deliver petrol, diesel and other refined products can also earn incredible amounts by storing them for a few months before delivery. One way to store oil or refined products is to keep them in tanker vessels, which is now being done to a great extent. As a result, tanker freight rates are record-high.

The cost of leasing an oil product tanker in late April was 3.5 times higher than the average for the past five years. Given this situation, if the largest product tanker company in the Nordic region were to lease all its vessels at these rates, in one month it would generate the equivalent of one fifth of its market capitalisation in net earnings. Naturally, this situation will not last; nor will current oil prices. However, we expect that the five traditional Nordic tanker companies we monitor will distribute a large portion of these surplus earnings to shareholders this year, and our dividend yield forecasts for these companies are between 20 and 50 per cent (1/5 to 1/2 of their valuations – that is not a typographical error). In the slightly longer term, however, once the oil market stabilises, the coronavirus crisis will still be a clearly negative factor for tanker companies as well if it means lower global oil consumption, thus reducing the demand for transporting oil and petroleum products.

Slower investment pace expected
However, the oil crisis is very negative for oil companies and their subcontractors, including many of the largest Nordic industrials, as well as for Norwegian banks. After the second major oil crisis in five years, it is reasonable to expect a far slower pace of capital spending for a long time in the oil industry; expectations of an upturn in oil prices in the near term are based primarily on lower production. The oil industry is still an important customer category for major Swedish industrials as well. For two of the largest, about 1/8 of their revenue last year was related to oil and gas.

Two economic sectors that have historically welcomed lower oil prices are airlines and cruise lines; unfortunately, they are not benefiting much from cheaper fuel today. These sectors do not have any significant effect on the Nordic stock market today, but if speculation about a structural decrease in demand for travel proves correct, this could have an indirect impact on a number of Nordic industrial giants that have shipyards and aircraft manufacturers as important customer categories.

There is a risk that a slow, weak recovery in demand for everything from oil-related infrastructure, aircraft and ships to retail and office space will disappoint investors going forward. Because of fears about all these problem sectors, stimulus measures will probably be needed to kick-start overall capital spending again after the crisis. Hopefully this will happen in areas where end-customer demand has not been structurally weakened, in the way it is feared the above-mentioned sectors may be.

Calls for a green deal, but will they be heeded?
Because of the economic collapse triggered by the COVID-19 pandemic, there is broad acceptance that robust monetary and fiscal stimulus measures are absolutely necessary. There have been calls from many quarters for us to seize this opportunity and try to rebuild society in a more ecologically sustainable way; it is definitely not just environmental movements and traditional green parties that want to see this, but also large parts of the business community.

In mid-April, a letter headlined GreenRecovery was published by 180 business executives, political leaders and non-governmental organisations in Europe – expressing their desire to see a more environmentally sustainable rebuilding of society after the crisis. Among the Nordic members of this alliance are Volvo, H&M, IKEA, Lego and members of the Confederation of European Paper Industries. On April 24, the national coordinator of the Fossil-Free Sweden initiative, together with the CEOs of Vattenfall, SSAB, ABB Power Grids Sweden and Scania, called for SEK 500 billion in government funds to be invested in seven strategic measures to give Sweden a zero-carbon reboot. A number of international organisations have declared the current crisis to be a historically unique opportunity to transform society by investing in greener technology, including the International Energy Agency and the International Monetary Fund.

Large-scale investments are needed to enable a transition to carbon-neutral technologies. According to a report by Morgan Stanley, USD 50 trillion in capital spending would be needed by 2050 in five decarbonising technologies: renewable energy, electric vehicles, hydrogen, carbon capture/storage and biofuels. That is a staggering amount, but when we compare it to SEB's estimates of what the world has spent so far on stimulus packages to overcome the coronavirus crisis – USD 17.5 trillion – the cost does not seem prohibitive.

However, not everyone agrees on the way forward. The president of the world's largest economy, the United States, recently banned anything that resembled his political opponents' ideas of a "green new deal" from the largest fiscal stimulus package in modern times. Some people consider a transformation of society to be an extravagance and a distraction from efforts to return to full employment and economic growth as quickly as possible. It remains to be seen what path the world will take, but we can assume that this issue will also be important to the stock market going forward. There are also many potential winners and losers in the Nordic stock market from such a social transformation. With Nordic companies accounting for 10 of the world's 50 most sustainable large enterprises in a ranking by Corporate Knights – a Canadian media and research company focused on sustainability issues and on environmental, social and governance (ESG) work – these companies should already be in a very attractive position if such a transition occurs.

Summary
When panic prevails in the financial markets, as in mid-March, there are also bargains in equities, but they are usually only available for a short while. The period we just went through was no exception, but the stock market upturn has been very uneven. For example, bank share prices are still very depressed. We are in the midst of a dramatic economic downturn and have seen sharp downgrades in corporate earnings forecasts. The oil crisis is having a significant impact on many companies. There is a risk of disappointments if normalisation is delayed, but there are also winners from the oil crisis such as tanker companies. After a mixed quarterly report period, but with earnings generally better than the downward revised forecasts published just prior to this, we are left with continued great uncertainty about the current quarter, which will probably be the worst ever for many companies.

However, a crisis entails not only suffering but often opportunities as well. A unique situation for a more sustainable restart has arisen, but will the calls for a "green new deal" to speed up the economic recovery after the coronavirus crisis be heeded? This will be an important issue for equity investors to follow, both in the Nordic region and internationally.

Theme: Renewable energy

Fresh start or sudden stop?

How will the coronavirus crisis impact the energy sector in a long-term perspective? Will an accelerated transition towards better environmental sustainability be seen as part of the solution to relaunch the economy after the COVID-19 pandemic? Or will this be considered an extravagance and a distraction from efforts to return to full employment and economic growth as quickly as possible?

Fast-growing energy sources

Solar and wind power are the fastest growing energy sources today. Their share of total electricity production in the 37 mainly affluent countries that make up the Organisation for Economic Cooperation and Development (OECD) has doubled in six years, driven by a dramatic fall in prices over the past decade, but production must triple again to replace coal-fired power. Listed companies in the renewable energy sector provide many widely different business models and investment opportunities.

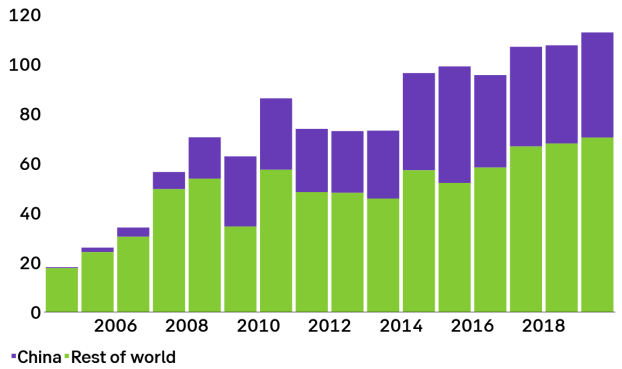
A crisis like the one we are now experiencing gives many people time to reflect on society and its development. Some changes in behaviour are likely, and even some fundamental values could potentially change. During the coronavirus crisis, there is broad acceptance that robust monetary and fiscal stimulus measures are absolutely crucial. However, it is an open question how events will unfold once the crisis is over. Will we take the chance to build a more sustainable society? Or will environmental issues take a back seat, just like in 2009?

In the enormous USD 2 trillion fiscal stimulus package that the United States enacted in late March to counter the negative economic impact of the coronavirus crisis, the Democrats wanted to extend the existing tax relief on solar and wind power and require airlines being rescued by government funding to reduce greenhouse gas emissions in return. However, President Donald Trump, who tried to get targeted support for the oil industry, refused to approve the stimulus package if these green measures were included. The Democrats gave in.

In Europe too, political leaders are divided between those who want to seize the opportunity and expand efforts to make the economy more sustainable now – when policy interventions (monetary and fiscal stimulus measures) are needed to spark a recovery – and those who simply think sustainability is too expensive now that we have been hit by the coronavirus pandemic.

One bright spot is South Korea, where success in fighting the virus gave the incumbent government a landslide victory in the country's April 15 election. That victory paves the way for their promising "green deal" with its aim of "a fossil-free society by 2050". It remains to be seen what path the world will take after the crisis, but choices made over the next year could have major long-term consequences.

The financial crisis was a tough setback for wind power investments outside China



Source: Bloomberg New Energy Finance

The chart shows annual investments in land-based wind power in billions of dollars in China and the rest of the world. Outside China, investments fell sharply in 2009. If we exclude Asia, it took until 2014 for investments to return to their 2008 record levels. There is a risk of a significant setback this time too, but conditions around the world are very different today.

The financial crisis: a cautionary tale

The 2008 financial crisis was a setback for investments in renewable energy. In 2009, the sharp growth trend in global renewable energy investments reversed. In Europe and the US, total investments in land-based wind power plunged 40 per cent, and despite a significant recovery as early as 2010, the records that were set in 2008 would not be surpassed until 2014. Global statistics looked better thanks to strong growth in China, but that market was virtually inaccessible to Western companies.

In the years before the financial crisis, growth in the sector was very strong. Between 2004 and 2008, global investments in renewable energy increased by 40 per cent annually. In the Nordic region and internationally, "alternative energy," as it was then called, was also a hot stock market sector.

In the Nordic region, the Danish wind turbine maker Vestas and the Norwegian solar panel producer REC topped the big companies, with share prices rising well over 100 per cent in 2007. That trend reversed sharply during the financial crisis. In 2008 REC shares plummeted 77 per cent, which turned out to be just the start of the downturn. Despite three new stock issues totalling nearly SEK 9 billion, REC – which had a higher valuation than both the aluminium giant Norsk Hydro and Norway's largest bank, DNB – now has a valuation of less than SEK 1 billion. The share price of Vestas nearly halved in 2008 and did not bottom out until 2012. Although the company has doubled its revenue since 2008 and has a far stronger position today, its share price did not surpass the 2008 record until December 2019.

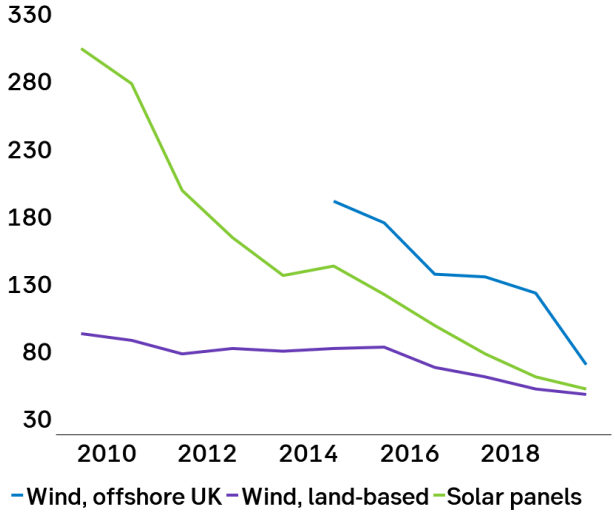
Big, important differences between now and then

With this painful memory fairly fresh in people's minds, it is not surprising that investors are worried about the prospects for renewable energy as a result of the coronavirus crisis. At the same time, it is important to note a number of key differences, which were also highlighted recently in a letter from 180 corporate executives, trade organisations and political decision makers in Europe urging such investments.

There have been rapid technological advances over the past 12 years; the cost-effectiveness and competitiveness of renewable energy have improved enormously. There is also access to complementary technologies for energy storage and power grid control that would enable a transition to a 100 per cent renewable electrical power supply. Furthermore, a great deal of experience has been gained from energy systems with a large share of renewable sources, and it has been possible to modify industry regulations.

In a broader perspective, technological conditions are also far better in a number of different sectors that need to contribute to this social transformation, including transport, manufacturing, real estate and agriculture. During this transformation, many of these sectors will also be

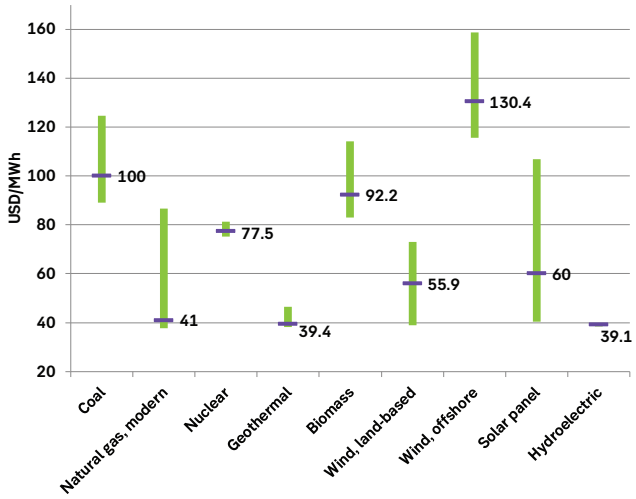
The cost-effectiveness of solar and wind power has improved dramatically



Source: Bloomberg New Energy Finance

The chart shows the total cost in dollars per megawatt hour of electricity from solar panels and land-based wind power globally for the period 2009-2019, as well as offshore-based wind power in the United Kingdom for the period 2014-2019. The unit price of electricity from solar power has fallen to less than one sixth in 10 years, while the price of land-based wind power has been halved. Offshore wind power is still far more expensive, but the cost trend is very favourable. Subsidies can speed up the switch to renewables, but solar and wind power are now competitive with fossil fuel alternatives even without subsidies.

Renewable power is very competitive, even without subsidies



Source: United States Energy Information Administration (EIA)

The chart shows the cost (highest, lowest and average) per MWh of electricity over an expected lifetime of 30 years for different kinds of power plants, excluding subsidies, for a US power plant that can be placed in production in 2023. Coal-fired power plants in these calculations are assumed to include 30-90 per cent statutory carbon dioxide recycling. In practice, the figures for US power plants are significantly improved today by tax credits, primarily for solar and offshore wind power and to a lesser extent for land-based wind power.

dependent on each other in order to achieve the desired effect. For example, no significant environmental gains are achieved by electric cars that run on coal power (though that is not the focus of this text).

The cost of producing one kilowatt hour of electricity with solar panels has decreased to less than one sixth of its 2009 level, and solar power is the cheapest source of electricity today in many countries. Meanwhile, the unit cost of land-based wind power has been halved, making it another one of the most competitive alternatives. In major economies, the battle today is usually between solar, wind, natural gas and coal, even entirely excluding subsidies. In many cases, various support measures and/or systems for pricing emissions from fossil-based alternatives can give renewables even larger cost advantages. Subsidies and regulations can of course affect how quickly a transition would occur.

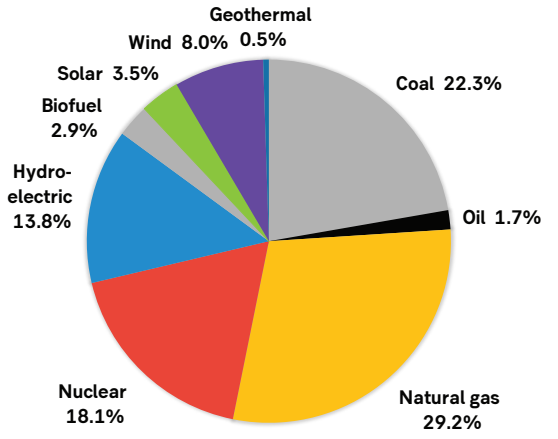
Another crucial difference between 2020 and 2009 is that central banks have intervened swiftly and forcefully in order to avoid a financial crisis on top of the economic collapse triggered by COVID-19. It is not the financial system that is broken this time. The credit crunch that caused so many problems in 2009 can thus hopefully be avoided.

Temporary standstill due to coronavirus

The direct impact of COVID-19 is naturally very negative for the renewable energy sector as well. Electricity prices have collapsed due to lower demand and plunging prices for natural gas, coal and in a number of key regions also for carbon emission allowances. Fortunately, electric utilities do not base their investment calculations for power plants, with their expected service life of 20-30 years of more, on this week's prices. So there have been few changes thus far in major power plant projects, although in cases where there have been delays, the postponement has been due to social distancing, which has temporarily shut down activity at construction sites and factories. If electricity prices remain as low as today for a lengthy period, the situation will be much more challenging. Although falling oil prices are negative for investments in renewable energy, this is not because oil is used to generate power (such use is negligible today), but because this makes the gigantic investments in renewable energy planned by numerous oil companies more difficult.

One segment of the renewable energy sector that was hit very hard by the pandemic rather quickly was solar panel installations on residential rooftops. In the US, many people have cancelled installations because of virus fears. New sales, which are largely made by door-to-door agents, have come to a complete standstill. Like cars and other capital goods, installing rooftop solar panels is a fairly big investment decision and will probably become a lower priority quickly if and when households start to worry about becoming unemployed. It remains to be seen what the recovery will look like.

OECD electricity production is dominated by fossil fuels, but renewables have a growing market share



Source: IEA

The chart shows 2019 electricity production in the OECD countries by energy source. Solar and wind energy have more than doubled their market share in six years but still account for less than 1/8 of total electricity production, while fossil fuels account for more than half.

Growing, but still low market penetration

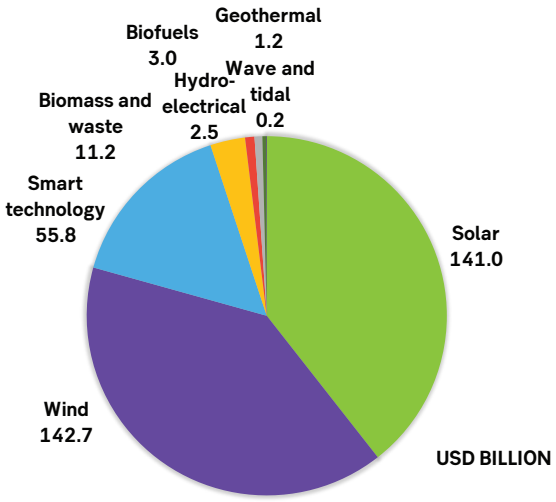
Although solar and wind energy are now seriously competitive, only 8 per cent of electricity production in the OECD is wind power, 3.5 per cent is solar and 0.5 per cent is geothermal. These sources have doubled their combined market share in six years, but still account for only 12 per cent of total electricity production. If we add hydroelectric power and biofuels, the total market share of renewable electricity is 29 per cent. Coal-fired power has fallen more than 10 percentage points since 2013 but still accounted for 22 per cent of production in 2019.

The transition from fossil fuels to renewables is making progress, but there is still much to do and stimulus measures can speed up the process.

Solar and wind power are the alternatives with the best growth potential going forward, given today's available and commercial technology. If they are to replace all remaining coal- and oil-based power, it means electricity production from solar and wind energy must become three times larger than today, even assuming no change in total electricity demand.

Energy efficiency measures have the potential to curb total electricity demand significantly, but at the same time there are a number of structural trends that may push up total demand. Calculations from the Swedish-based power company Vattenfall show that if all passenger cars in Sweden were replaced with electric cars, total electricity consumption in the country would increase by about 9 per cent. In Germany, major environmental gains could be made by heating homes with heat pumps instead of boilers, but even if that significantly reduced total energy use, the need for electricity would increase. In manufacturing, there is great potential for energy efficiency improvements and environmental gains from electrification, but that increases the need for electricity. Overall, however, the IEA foresees only a weak increase in total electricity consumption in the OECD countries over the next 20 years, but strong growth in emerging markets, resulting in aggregate global growth in demand of more than 2 per cent annually.

In 2019, global investments in renewables were dominated by solar and wind power



Source: Bloomberg New Energy Finance

The chart shows 2019 investments in renewable energy and complementary technologies in billions of dollars by category. Solar and wind power dominate, while wave and tidal energy as well as geothermal energy still play a much smaller role.

Independent power producers are attracting investors with renewable sources and generous dividends

Source: Bloomberg

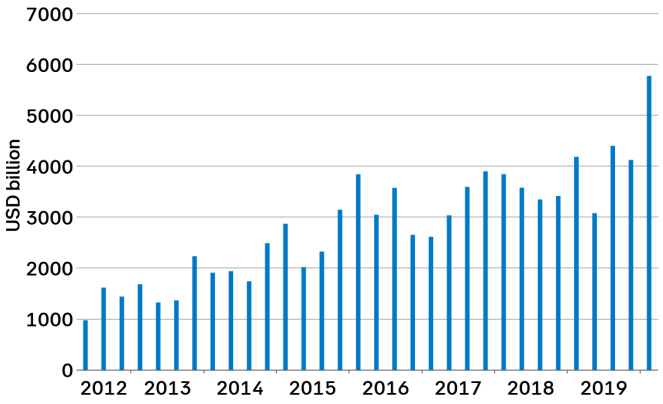
The chart shows the consensus dividend forecast as a percentage of stock market capitalisation during the next 12 months for an equally weighted portfolio of seven listed power producers in the US, Canada and Germany that focus on renewable energy sources.

Solar and wind power dominate
Renewable energy includes many different sources but is completely dominated today by hydroelectric, wind and solar power. Wind power is still primarily from land-based wind farms, but offshore wind farms are increasingly important, with costs falling even faster in recent years. With solar power, the demand is primarily for solar panels, while thermal solar energy plays a lesser role. According to Bloomberg NEF, in 2019 investments in new thermal solar energy facilities totalled USD 4.6 billion, compared to USD 141 billion in solar panels.

There are many exciting new technologies to harness tidal, wave and geothermal energy. They could potentially become more important in the future, but they are still relatively insignificant. Ocean tides have the attractive property of being predictable far in advance, which can make tidal energy a good complement to both solar and wind power. Geothermal energy has the advantage of providing stable, predictable flows. However, tidal and geothermal energy are both restricted by the relatively limited number of places with the right natural conditions.

Even today, geothermal energy has good conditions necessary to play a significantly larger role in heating buildings using ground source pumps – even beyond the Nordic region – thus contributing to improved efficiency and reduced emissions. In Germany, which is otherwise among the most environmentally progressive countries in the world, 25 per cent of all buildings are still heated with oil, and fossil fuels together account for 80 per cent, while geothermal heat pumps still only represent 2 per cent, according to a 2019 report from the International Energy Agency (IEA). Heating accounts for a full 40 per cent of Germany's total greenhouse gas emissions, and heating of buildings is a significant part of this.

Solar panel suppliers have shown strong revenue growth



Source: Bloomberg

The chart shows total quarterly revenue for the five largest listed, dedicated solar panel makers, in billions of dollars.

Renewable energy equities: Sun in China, wind in Denmark
For equity investors, the renewable energy sector offers many different alternatives. There are numerous small, often unprofitable, but sometimes very innovative listed companies in the sector. There are also a number of large and often profitable companies, which we will focus on below.

Energy producers and project developers attract investors with dividends
A large share of the world's renewable energy generation assets is owned by large, diversified energy producers and electricity distributors, whose production is often still dominated by fossil-fuelled plants. There are also at least 20 listed independent energy producers totally focused on renewable energy sources, with market capitalisations ranging from SEK 5 billion to SEK 400 billion, listed in North America or Europe. These companies often have diversified portfolios in terms of technology and geography, but there are also companies that focus on specific geographies and technologies, for instance solar power in India, geothermal alone or offshore wind power alone. These include integrated project development companies and power plant operators as well as some structured very much like investment companies, where technical management is outsourced to external parties and electricity production is sold through long-term contracts. Many of these power producers aim to pay competitive, stable dividends.

The wind power industry is rapidly consolidating
For investors looking for more direct exposure to expected future growth in the industry, equipment suppliers are probably the most attractive alternative.

The wind power industry is relatively consolidated, with four major turbine suppliers: the Danish firm Vestas, the German/Spanish company Siemens Gamesa and the Chinese producer Xinjiang Goldwind. US-based General Electric (GE) is also an important player in wind power, but these operations account for only about 16 per cent of the group's revenue. There are also various smaller Chinese players, German-based Nordex, the Indian firm Suzlon and a large number of very small market players. Many of the latter companies suffer from weak profitability. Combined with continued rapid technological advances (which require resources for activities including product development) and challenges such as the coronavirus crisis, this suggests that the leading market players will further strengthen their positions.

China is the dominant force in solar panels
The solar energy industry is heavily dominated by China, which accounts for more than 70 per cent of the world's production capacity of silicon-based solar panels. Compared to wind turbines, the manufacture of solar panels is far more fragmented, and no single company controls more than 5-6 per cent of the market. Of the twelve largest manufacturers of silicon-based solar panels, all are from China except one that is South Korean and one with its head office in Canada but most of its production in China. The founder and main owner is also from China.

China is likewise the largest producer of silicon raw material, with 60 per cent of global capacity, but its dominance here is not as large; there are also major producers in South Korea and Germany. Non-silicon-based thin-film solar panels are dominated by the US company First Solar, which alone has more than 60 per cent of global capacity. However, thin-film solar panels represent a relatively small share of the solar panel market; calculated in watts of energy production capacity, silicon-based solar panels are 20 times bigger. Because sharp price decreases brought success and growth to the solar energy industry over the past decade, many producers are unfortunately struggling with weak profitability. One significant exception is the Chinese company Longi Green Energy, which is also one of the very biggest market players.

Smart technology offers high profitability

However, a functioning solar power unit requires more than the actual panels. With profits being squeezed, and panel production highly capital-intensive, smart technological solutions are in fact crucial to solar inverter producers. Inverters convert the power generated by solar panels and make it usable. Inverter suppliers often sell peripheral equipment for control systems and battery packs for households with rooftop solar panels. The solar inverter industry is not at all dominated by Chinese players; the two biggest companies in terms of market capitalisation are in the US and Israel. The industry also includes listed companies in Germany and China.

The most successful companies in this niche not only have good margins, which a few of the panel makers also have; they also provide a very good return on investments, since they require far less tied-up capital. Technological advances have been rapid, and the market shares of the various players in the industry have changed significantly over the past seven years.

Summary

The world is at an important crossroads. Will investments in sustainability, including renewable energy, further accelerate after the coronavirus crisis? Or will this crisis – like the last financial crisis – slow down the transition to sustainability? The cost-effectiveness of renewable energy sources has improved enormously over the past decade, and although renewables doubled their share of capacity over the past six years, this capacity needs to triple again just to replace existing coal power. Since this must nonetheless happen sooner or later, we believe measures that speed up this development would be particularly timely for the economy and employment over the next few years and for the planet in a long-term perspective. There are many attractive investment opportunities in the sector. The renewable energy sector is now well-represented in stock markets around the world – including many large, profitable companies with different business models and specialities.

Theme: Oil

Divergent strategies, collapsing demand behind price crash

The oil market was shocked when Saudi Arabia vindictively declared an oil price war against Russia, following a meeting of OPEC+ members on March 6 this year, where Russia refused to approve further production cuts. Oil prices – in a downward trend even before the outbreak of the COVID-19 pandemic – collapsed. West Texas intermediate (WTI) oil temporarily traded as low as minus USD 40/barrel, since no one wanted to receive it. Although the imbalance has diminished, global demand is still lower than supply. The surplus is rapidly filling up available storage capacity. This has made the oil market players realise that they had misjudged the size of the surplus and that dramatic production cuts are needed.

After years of concerted efforts, Russia was able to trim its costs and can now balance its federal budget at an oil price of USD 40/barrel. After three years of reduced production, Russia thus wanted to return to normal output by means of gradual increases, regardless of what this would do to the price. Saudi Arabia, for its part, needs an oil price of USD 80/barrel to achieved a balanced budget. By means of reduced production, it thus eagerly tried to boost the price of oil as much as possible. These two widely divergent needs and strategies were at the heart of the price war between these oil powers.

Pandemic caused demand collapse

As if the price war between two major oil powers were not bad enough, it coincided with the realisation in the Western world that the COVID-19 virus did not respect national borders, but was about to strike with force in Europe and later also in the United States. Oil market players became aware that demand was not only falling, but collapsing. In late March, demand was about 70 per cent of normal, as a consequence of lockdowns while waiting for the virus to fade away. Historically, such a collapse in demand had never happened before.

Sharply reduced supply

OPEC+ (the OPEC oil cartel plus Russia and several other non-OPEC countries) reduced production by 9.7 million barrels/day as of May 1, a very large cut from a historical perspective. Production outside OPEC+ is also falling – not necessarily on a voluntary basis, but rather as an effect of low prices and Norway's pledge to refrain from ramping up production during the second half of 2020. Production in North America has probably already decreased by around 2 million barrels/day. So overall global production is falling fast.

Robust growth in American shale oil production
While global production of traditional oil is struggling, American shale oil is flourishing like never before. For the past four years, US production of liquid petroleum has risen by 5.5 million barrels/day to 20 million barrels/day. As a result, the US is now self-sufficient in oil. US supply and demand were in balance at a level of just over 20 million barrels/day. The US has thus added more supply to the market during this period than the entire output of Iraq, one of OPEC's largest producers.

Although shale oil production has grown robustly and challenged traditional oil extraction, investments in the latter have been extremely limited since the last oil price collapse in 2014/15. The pipeline of new projects that will go into production in the coming years was already thin, and even before the current price collapse there were already clear warning signs of falling oil production outside OPEC+ from 2021 onward. This decline will now be compounded by reduced investments in traditional oil extraction and in shale oil production, with shale oil production being hit harder by investment cuts. Conventional oil production will only decrease by 5 percent per year, even if the companies completely stop investing.

Shale oil behind both instability and possible stability?
So while the introduction of US shale oil production has led to a very unstable oil market, it also has the potential to help the market stabilise considerably faster than history indicates. But this requires that OPEC is not too greedy about oil prices. Assuming that OPEC+ will allow the oil price to fluctuate at around 40 USD/barrel for a while, the market will be balanced again within a year.

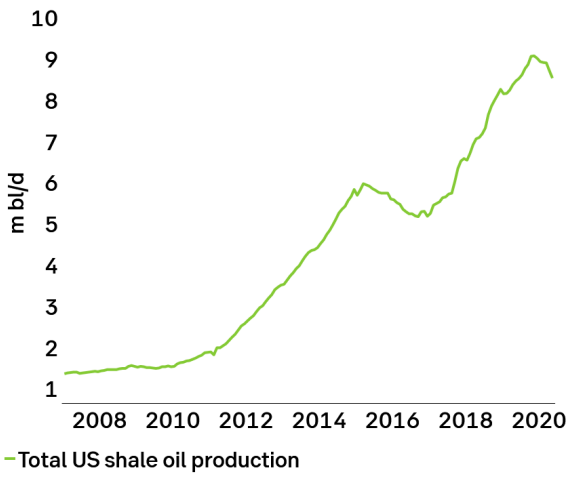
Another scenario would be that demand recovers to about 90 per cent of normal. If this happened relatively fast, the market could potentially be balanced as early as this summer and Brent crude oil would be priced at USD 35/ barrel instead of the current forecast of USD 20-25/barrel.

Demand will come back
The global oil market is currently in a painful rebalancing process. Producers all over the world are healing their wounds, cutting costs and reducing new production. On the other hand, today's low prices will lay the foundation for higher prices going forward. Our estimate is that global oil demand will revert to 100 million barrels/day some time in 2021/22. At present, global consumption is very low. Expressed in barrels per person annually, the global average is 5 and for Europe 10. Sweden and Norway have an average consumption of 16-18 barrels per person annually, while the US is at 20. For Sweden and Norway, if we also count indirect oil consumption, via imports of all types of products, annual consumption is instead 36 barrels per person.

The big picture, however, is that US shale oil production is falling sharply and investors in this area are hesitant after earlier problems, with production growth slowing in 2019 when oil prices were close to USD 60/barrel. Investments in traditional oil are also now at a low level.

Looking further ahead, an increasing population and higher energy consumption per person will lead to a long-term increase in demand, with the current low price certainly benefiting oil consumption – but with sustainability aspects and environmental awareness climbing ever higher on the list of things that determine consumer demand.

Explosive growth in production – an important factor behind the current imbalance



Source: Bloomberg

The above chart shows production of US shale oil since 2007 in millions of barrels per day – with growth of nearly 8 million barrels per day by the end of 2019. Although this is not the only reason for the current oil market imbalance, it is a strong contributing factor and is especially irritating to Russia.

Greater sustainability focus will increase competition among oil producers
With the US becoming self-sufficient and President Trump happy to talk about US energy dominance – which includes oil and natural gas exports as part of the plan and the recent US trade agreement with China – of course competition will increase in the oil market.

Competition in the overall energy sector has naturally also increased, since sustainable and renewable energy sources are moving higher and higher on the agenda. For example, solar and wind power are the fastest growing energy sources today. Their share of total electricity generation in the OECD countries has doubled in six years.

As part of the gigantic USD 2 trillion fiscal stimulus package that the US launched in late March to combat the adverse economic impact of the coronavirus crisis, Democrats wanted to include extended tax relief for solar and wind power, as well as requirements that in exchange for being rescued by government funds, airlines must reduce their greenhouse gas emissions. On the other side stood Donald Trump, who refused to approve the stimulus package if these green elements were included. The Democrats were forced to give in this time. However, sustainability issues are a major focus of attention and the pressure for actions similar to Democratic wishes is increasing. Read more about renewable energy in our theme article "Renewable energy – fresh start or sudden stop?" on page 18. During the foreseeable future, we will be dependent on oil, although the volume is more difficult to forecast. In the future, energy producers will fight for market share by making themselves relevant and by meeting consumer needs. Energy demand will generally increase at the pace of population growth, but it remains to be seen what kind of energy this population needs and wants.

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