SEB House View

18 May 2022

SEB

Overview

House View factors

Macro and Markets

Market and Fair Value Indicators

In Focus

Asset Class and Sector Views

The ghosts of Covid chasing markets

Investment Regime: Inflation and the fight to control it

- Markets have a hard time digesting the changed inflationary environment: High and persistent data sets the need for a long tightening from FED on the agenda
- We are surprised by the resilience of the inflation impulse and the harsh reaction in markets, but there are several events in play
  - One of them that causes trouble is that the large FAANGS are in a bear trend and in some sense the last part of the market to fall
  - At the same time bond markets are more resilient and pointing to inflation stabilizing at levels that probably is acceptable to the Fed and other central banks
- Why not sell all stocks?
  - The key to a changed direction in equities is the inflation situation and the risk that the FED will have to push the economy into recession to break inflation
    - The Fed has sharpened the outlook for its policies naming the need and possible risk to growth through policies, this negative narrative is driving sentiment
  - The main reason for the inflation surge is low inventories after the covid period
    - They are now rising and inherently that could take some heat of prices
  - The high activity level also shows in wages that rise but there are signs of levelling out – the markets will get in balance
- Commodity prices was a major culprit in the inflation surge but have stabilized and more countries are now looking at new sources to mitigate the dependency on Russia
- Chinese lockdowns have worsened the supply problems and there are still just small signs of a softer policy. But if that happens some of the inflationary pressure will abate and the world would be exposed to the only country actively fighting its weak demand, this will change global financial conditions

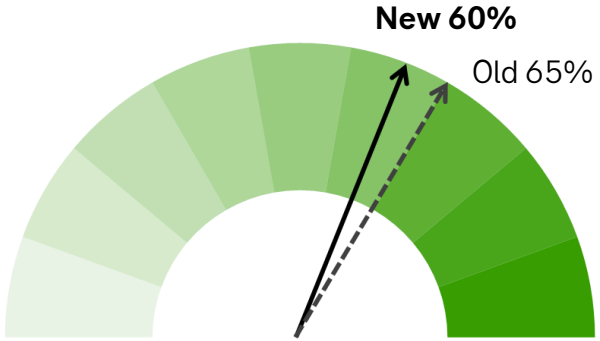
We change our risk utilization to 60: thereby we don't rebalance

- Our view is that we are likely entering a trading range without firm positive drivers
- The idea behind this is that we are in a weak trend and it is tricky to call the bottom
- But going forward we can see drivers for a change – the present trend is "rich" in sense of sentiment

Investment Regime

Our regime-based framework defines the major characteristics of the investment regime

Speedometer



The speedometer controls to what extent the portfolios should utilize their risk budgets. It is connected to the model portfolio (page 4) which at all times utilizes its risk budget in-line with the speedometer. In a very general sense it can be interpreted as equities on/off (with 50% being neutral).

Investment Regime: Growth will most likely persist

The world will continue to grow, avoiding recession is the next challenge

Effects of the post Covid issues is starting to show in several pars of the world. In general growth is downgraded as higher inflation is expected to take a toll on consumption. This leads to a series of down revisions of growth forecasts. This occurs at a period that some analysts label as the last stage of the business cycle while others see a good backdrop for continued growth into 2023. If we look at the long-term factors such as leverage in the economy, possible fiscal policies, outlook for investments and in general the pent-up demand from last year, the likelihood for growth is good, but the fight on inflation will determine the length of the cycle.

Central banks must reset the trust in the inflation fight

The worst situation for central banks is if they loose control over inflation expectations. Too high expectations decreases consumption and recession risk rises. In that light, we may see a shift in FED policy and the effects that has led to on the yield curve. The million dollar question is if what's discounted now is enough or if the FED and other CBs need to go further and raise rates even more. A quick and dirty way to look at this is to compare what's discounted with inflation expectations as they are priced in the bond markets. In that case the present expected FED moves are close to what will be needed.

Fiscal policies is the new black....the thing

Fiscal policies became popular during Covid and as politicians acquired a taste for it we will likely see more done. China has acted to help the economy. In Europe, Germany and other countries have started to spend more on defense. Environmental policy goals requires investments. In general we will see fiscal policies as driver for growth and investments.

Earnings forecasts are good, but we remain wary of downside risks

As long as we continue to expect good growth the picture will be reasonably benign. The latest earnings season has indicated that companies have coped well with challenges in rising prices and bottlenecks as results were better than expected, but we are more cautious in the forthcoming earnings season.

Macro Stable but challenged post Covid growth...	• 2022 GDP forecasts are positive, but have been adjusted down due to inflation issues • The inflation/growth balance is floating • Commodities and new supply issues will affect inflation
Central banks A decisive road to tightness	• FED tone has shifted to focus on inflation, which has lead to lower expectations • Financial conditions have tightened substantially
Politics A new situation. Chinese support will rise	• We are getting a new set of fiscal measures to meet the Russia/Ukraine situation • The Chinese government is supporting the economy with more stimulus
Corporates Managing risks; earnings forecasts are so far good	• Earnings will likely stay strong, but price pressures is still a risk • As yields remain volatile we monitor multiple expansions • Cost pressures from commodities is a risk factor

RISKS Persistent inflation | FED policy mistake | Weaker earnings | Supply disruptions

Asset Allocation

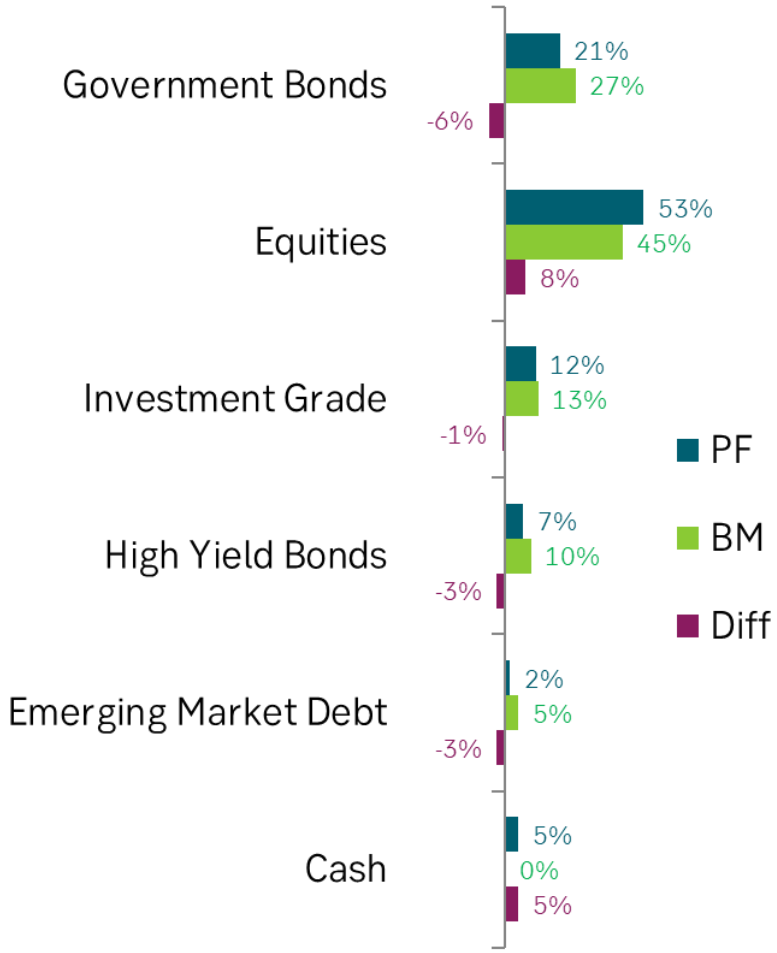
Markets are still challenged, but as we decrease exposure we still prefer to focus on equities

- The fight against inflation still drives markets
  - In a slightly longer perspective equities is the asset class with best inflationary characteristics, but as the outlook for inflation this year still is an open question uncertainty prevails
- One matter that probably creates some uncertainty is that so much of last years strength in equities was in growth stocks, which are sensitive to interest rate levels, and will not benefit from inflationary pressures, so we may see elevated volatility
- The US yield curve has flattened and can be seen as a sign of an upcoming recession
  - Our view is that yields are distorted by central banks and we now pay less attention to this
  - We expect markets to overall perform well for the next 12 months after the flattening.
- We have seen a set of downward revisions of growth forecasts, which is usually not a good sign, but markets have priced some of the effect
  - EPS forecasts are moving around, but levels are still competitive compared to bonds
  - If bonds stabilize, as they seem to do, that will help stocks to stabilize
    - It all depends on the central bank and inflation outlook

Government bond markets have stabilized, this can indicate trust in fed policies and maybe to some extent risk of lower growth

- We still maintain underweight in government bonds as there are still some uncertainties in the inflation outlook and the risk-reward situation for equities is more compelling
- Corporate bonds has somewhat better spread levels, which is indicative of low expected risk for recession, but we prefer to remain defensive on corporate bonds due to duration risks

Model Portfolio



Long only portfolio. Yearly VaR(95%) ex. mean between 7% and 21%.No restrictions on the individual asset classes. The weights are set manually by the House View committee; i.e. they are not based upon an optimization model.

Regional equity allocation

We hold an overweight to the US, the dollar maintains its strength

- The US is often considered a safe heaven region, which leads to a stronger USD as capital flights to safety amid risk-off sentiment
- The US economy is the least affected by the war, albeit some of the sector composition is negatively impacted by higher interest rates
  - A stabilization in bond yields would lead to some optionality
- There is also a risk or possibility, depending on positioning, that the signal sent from the yield curve will later be beneficiary for growth stocks, even if it probably is a bit too early at this stage

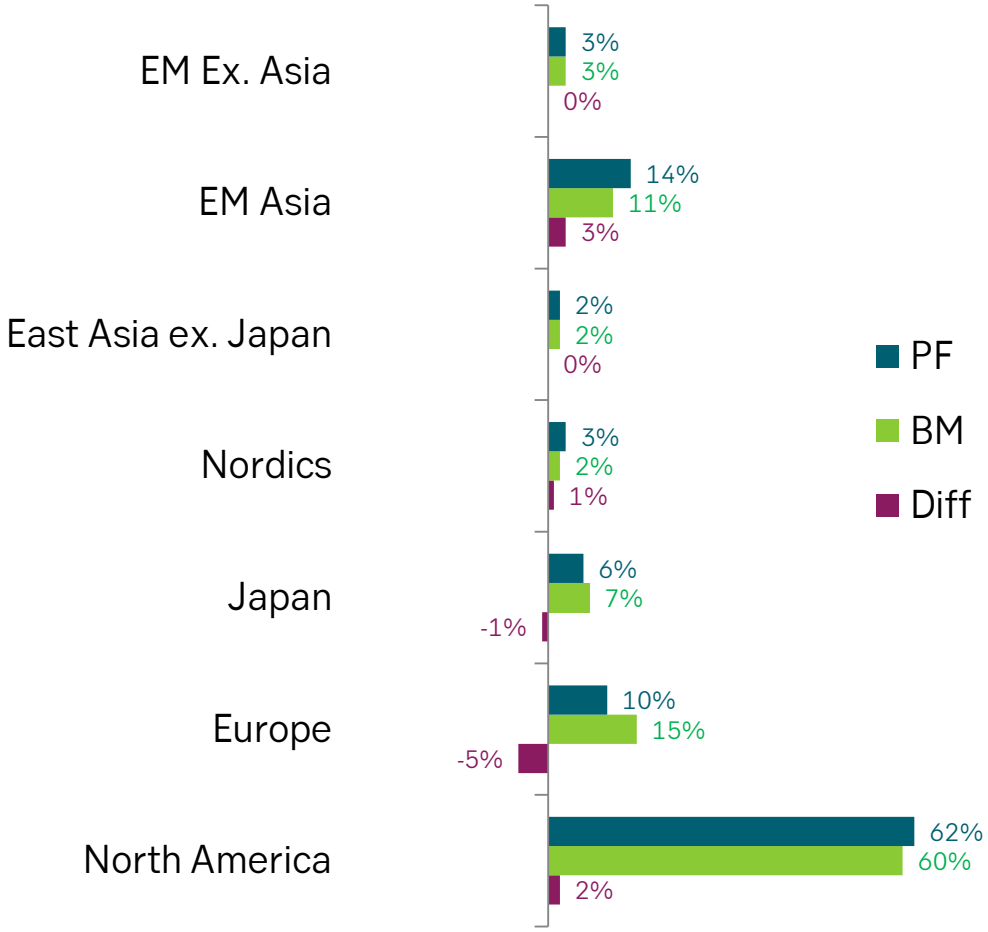
Europe is still in a tricky position, so we prefer to keep our underweight to the region

- Consumer sentiment has taken quite a hit, but macro leading indicators are still decent
- It is also interesting to note that big segments of the European equity markets are heavily discounted and will be in a good position once the outlook stabilizes
- In the long run the sector composition of Europe is possibly quite resilient and advantageous in an inflationary environment
  - Europe is more of a value region than the US, but given the current ambiguous sentiment, its probably too early to enter that position

Emerging markets, USD and China...

- Our overweight to EM Asia is challenged by a loss of confidence due to lockdowns
  - The determination of the policy framework in China should be supportive if policies change, but that is a big if
  - China's strategy is pro-growth as there is an ambition to increase GDP growth to 5.5% in 2022, however, after that target seems a bit too hopeful after recent data
- EM ex Asia is to a large extent commodity producers in South America
  - The region is in an interesting position, but headwinds from a strong USD and ESG considerations do not make it attractive enough

Regional equity positioning



Benchmark is MSCI All Country

Sector allocation

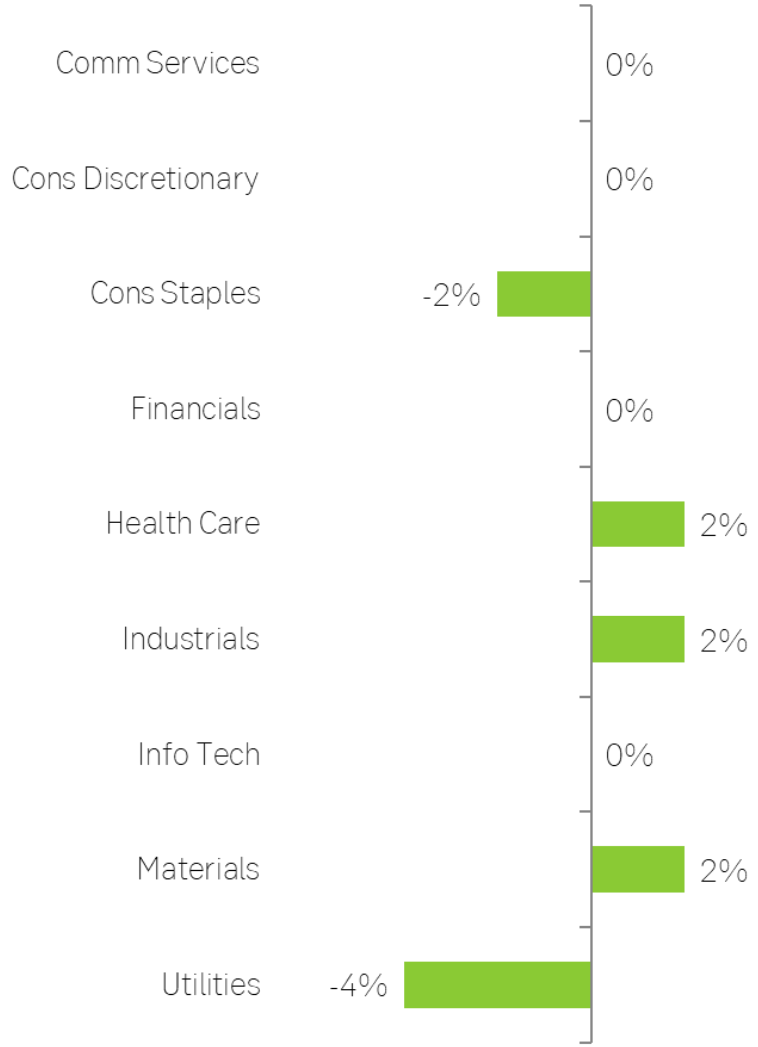
We have a slightly inflation positive position

- We focus on the higher risk of inflation and what that means for different sectors – pricing power is a competitive advantage
- Another thing that carries our thinking is that we will have potentially elevated inflation levels leading us to overweight sectors with decent pricing capacity
- Materials and Industrials have had strong earnings growth and usually benefit from their ability to raise prices in times of rising inflation
- Materials benefits from both higher demand and prices
  - We have seen strong upward earnings revisions which should benefit the sector
  - Materials also has some control over prices and the sanctions on Russia can create some opportunities
- Industrials is in a good position in this inflationary environment
  - Traditional base industries are often able to lift prices and respond to new volumes
    - There is a likelihood that we will see more capex in the commodity space that will in turn increase demand for industrial goods and services
- Health Care remains attractive as it has defensive characteristics, and an aging-global population is a positive long-term trend

Our strategy reflects our view that growth and inflation will remain important

- Bond yields will move upwards as soon as the Ukraine situation becomes more stable
- Higher inflation will likely persist for a while, leading us to have a negative outlook for bond proxy sectors, which have so far contributed negatively to our performance
  - Utilities and Consumer Staples correlate with bonds and should find it difficult to perform in an inflationary environment
  - They also tend to be low-growth sectors, which makes them less appealing in the long run

Sector positioning



Risks to the investment regime

An inflationary environment that remains elevated and broader than expected

- The combination of higher prices due to the war in Ukraine, the supply chain disruptions in China and strong pent-up demand due to Covid has lead to an uptick and broadening of price pressures
  - In particular the recent lockdowns in China with it's zero-Covid policy in place has added to the concerns of the inflation outlook
    - Global supply-chain disruptions, which seemed to be easing a month ago, may now be ticking upwards as long as lockdowns in China stay in place
- And although global central banks are now focusing on taming inflation, the risk is that the factors driving up inflation are out of the banks control
  - That is, the Fed can affect the demand side of the economy, but the supply side, which has been affected by supply chain disruptions, is out of its control

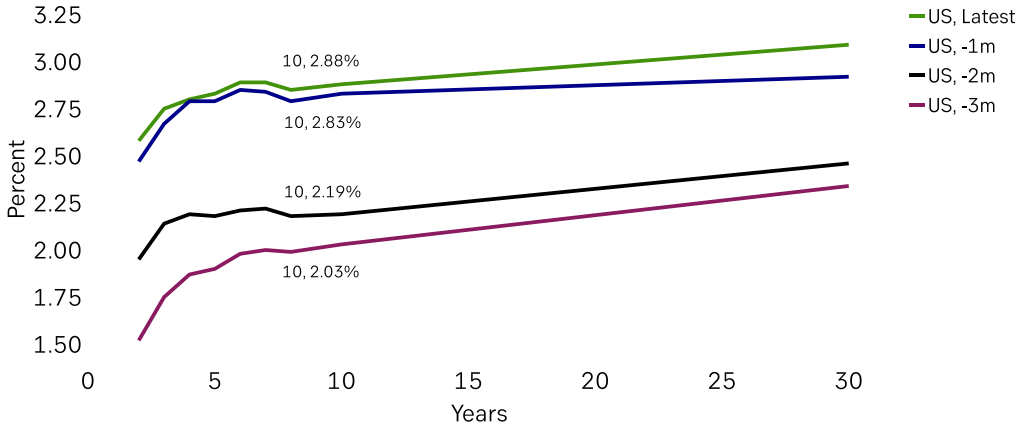
Bond markets will likely remain volatile moving forward as central banks thread forward with monetary tightening

- The Fed has signaled two more 50 bps rate hikes at the next two meetings as well as the start of quantitative tightening on June 1st
  - The Fed will start by cutting the balance sheet by $47.5 bn a month for three months and then come September it will cut $95 bn a month
  - The risk here is that the QT cycle could result in an upheaval in the bond market as it did last time in 2018-2019
- Thus, there is a risk that in the coming months volatility in rates and equities will remain elevated

China's zero-Covid policy and the war in Ukraine drag out for longer than expected and keep price pressures elevated

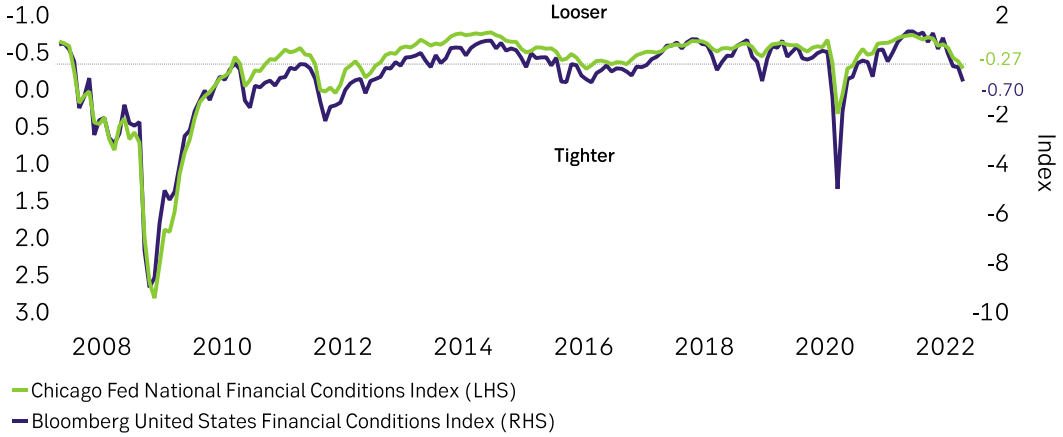
- The risk of a an extended zero-Covid policy from China will affect global trade
- The war is another political event that could have an unexpected outcome
  - However, in case any of these events have a shorter duration than currently expected, we could see an upswing in the markets

Figure 1: Bond yields have swiftly move higher over the last months as markets priced in a rapid tightening of monetary policy



Source: Macrobond, SEB

Figure 2: Financial conditions are now tighter as rates are moving higher and particularly as liquidity is expected to diminish due to quantitative tightening



Source: Macrobond, SEB

Return Estimates

Figure 1: 12 month forward looking return expectations

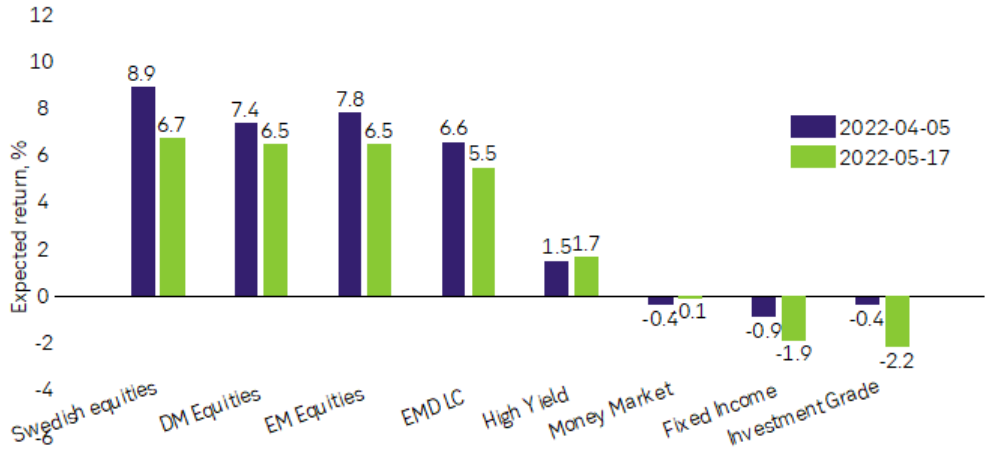


Figure 2: 12 month forward looking return expectations for equities and bonds

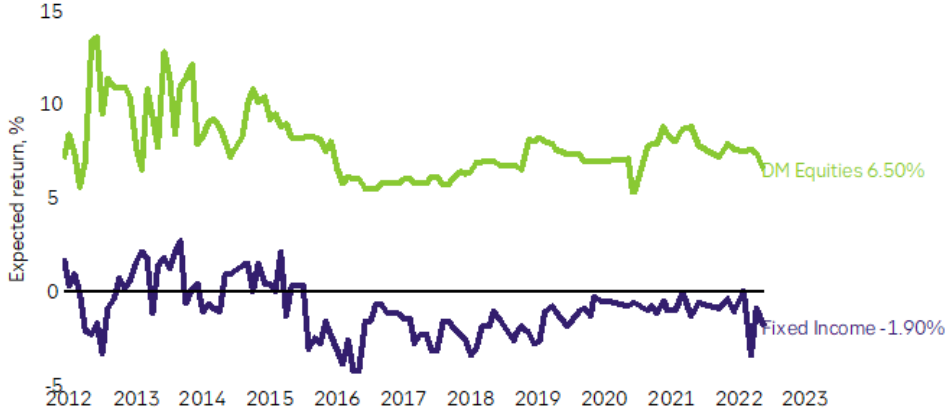


Figure 3: Absolute expected returns

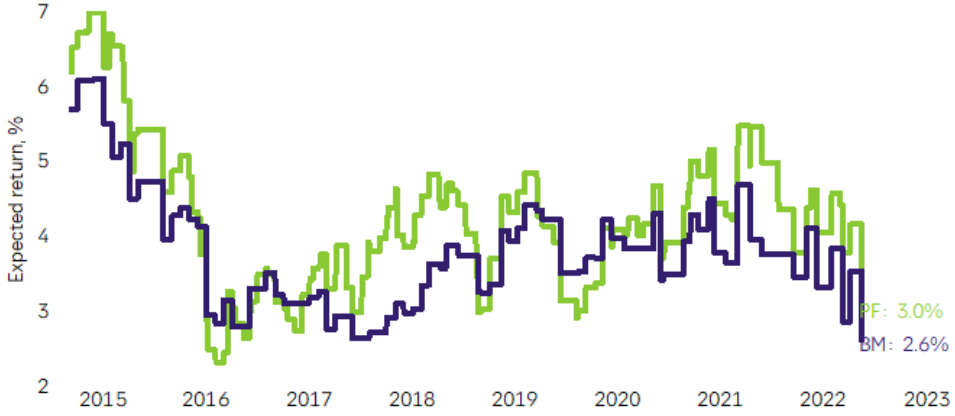
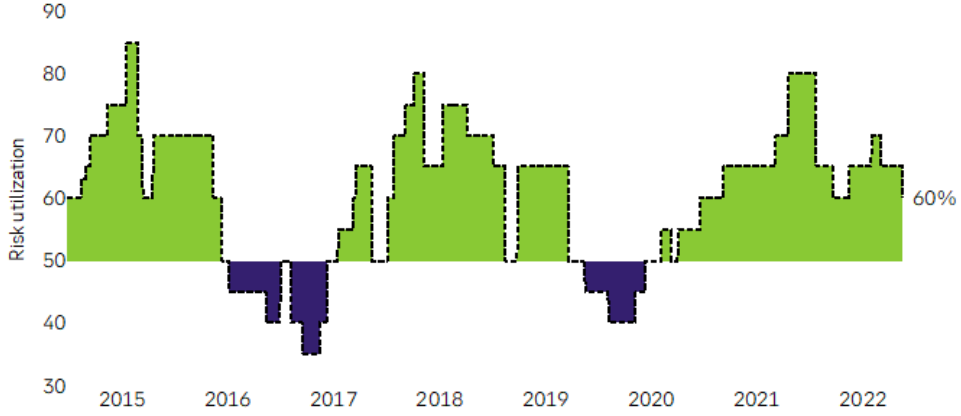


Figure 4: Risk utilization since inception



Historical House View Allocation

Figure 1: Equities

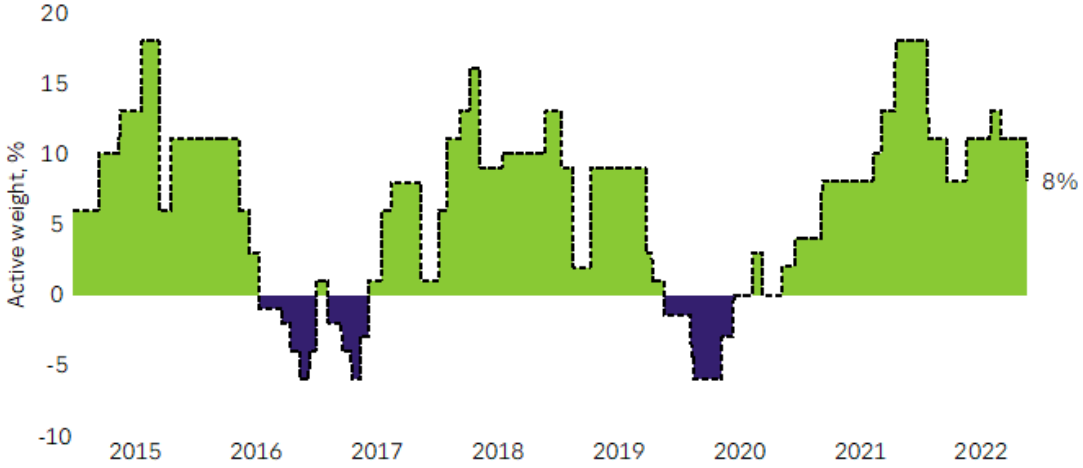


Figure 2: High Yield

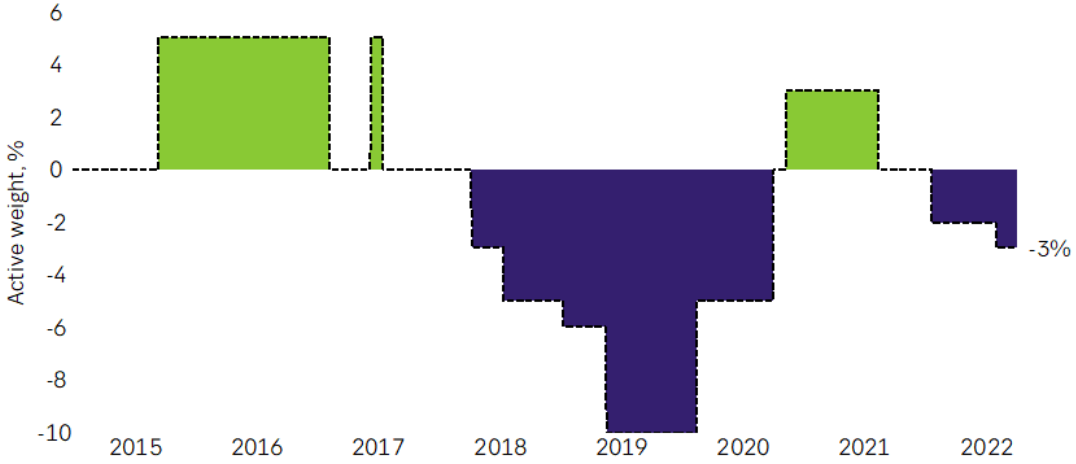


Figure 3: Emerging Market Debt

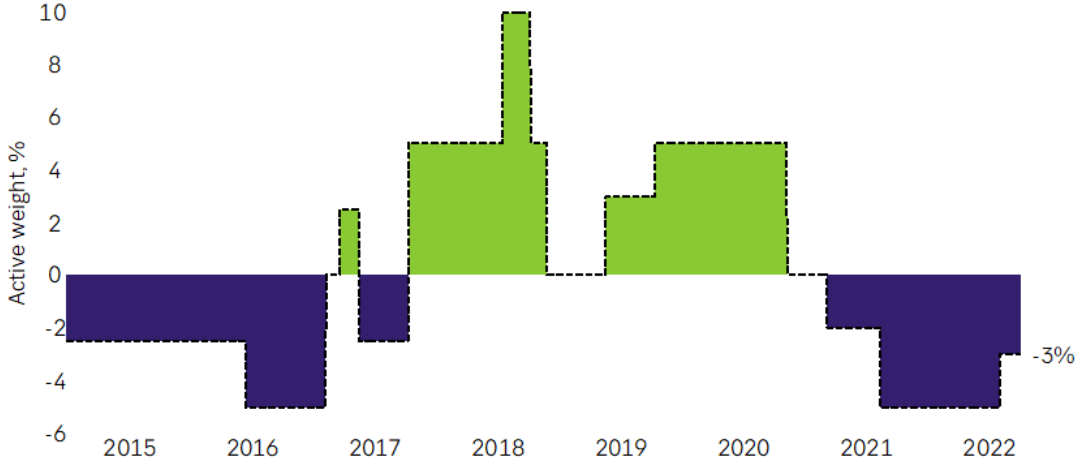
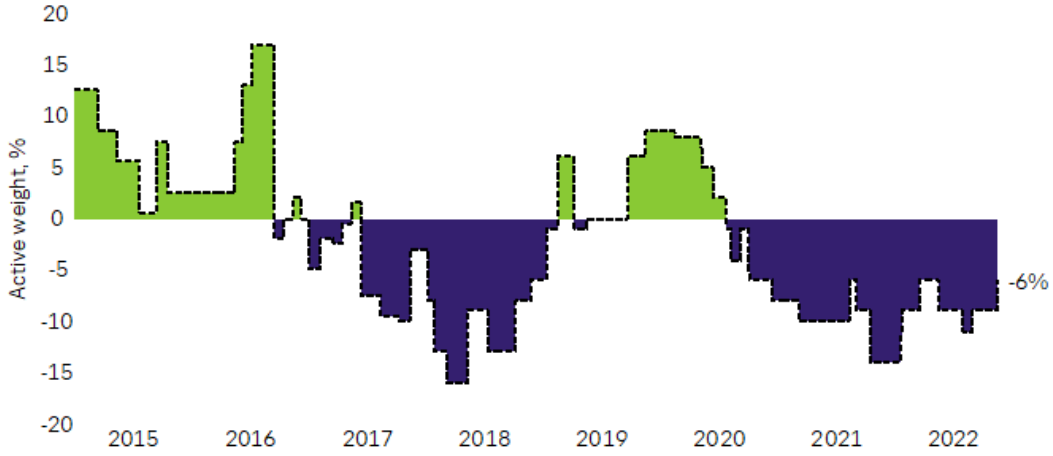


Figure 4: Fixed Income*



* The 2014-2015 combined overweight to equities and fixed income was financed by an underweight to Investment Grade, Commodities, and EMD.

Overview

House View factors

Macro and Markets

Market and Fair Value Indicators

In Focus

Asset Class and Sector Views

House View decision variables

Central Banks remain important as investors focus on the Fed's ability to hike rates and bring down inflation without causing a recession

- The Fed hiked interest rates by 50 bps during its last meeting and is expected to start reducing its massive balance sheet next month
  - The question now is whether the Fed can normalize its policy in order to bring down inflation without breaking the economy
- The ECB is also expected to end QE and start to raise interest rates in July

Macro data is slowing down, but is still solid, as inflation has stayed at elevated levels and US economic activity expands, albeit, at a slower pace

- The war in Ukraine still weighs on the economic outlook and confidence in Europe
- China's economy contracted last month, as the country maintains its zero-Covid policy
  - Lockdowns have hit demand for services and led to more severe supply-constraints that have disrupted activity in the manufacturing sector

Politics is becoming slightly less important as investors focus more on central banks and macro, and much less on the war in Ukraine

- Nonetheless, China's policies, which set the rules for its zero-Covid policy, is still important as it affects global supply chains and demand

Earnings become less important as the earnings season comes to an end

- Earnings was more positive than expected, both in terms of sales and earnings
  - Companies have been able to maintain margins by passing on higher costs to consumers, and inflation has also contributed to higher reported sales
  - We remain wary of how long pricing power against inflation can persist

On a 3-6M horizon the House View Committee holds a positive view on risky assets and remain overweight to equities, but we are wary of downside risks

- One of the biggest risks is still the Ukraine/Russia conflict, but we also view restrictive China policies and Fed policy mistakes as scenarios that could deter economic growth

Figure 1: Central Banks and Macro are still the most important variables for our risk taking, as markets focus more on policy normalization and incoming inflation data

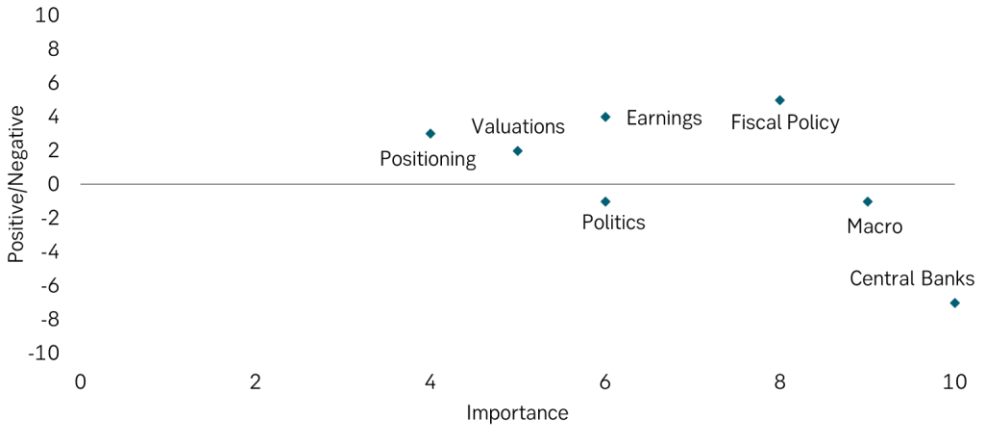
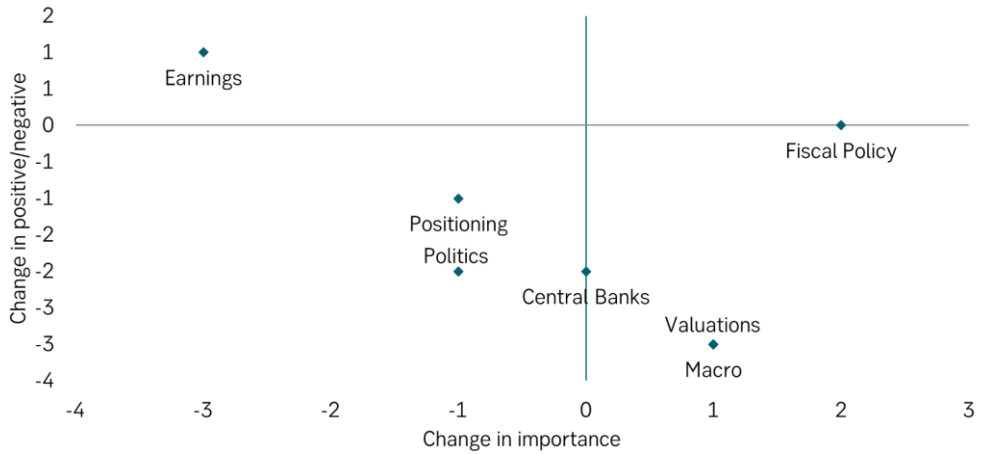


Figure 2: Fiscal policy has become more important as China plans for huge infrastructure investments. The earnings season is almost behind us and the war in Ukraine is fading



Overview

House View factors

Macro and Markets

Market and Fair Value Indicators

In Focus

Asset Class and Sector Views

Developments in the Markets

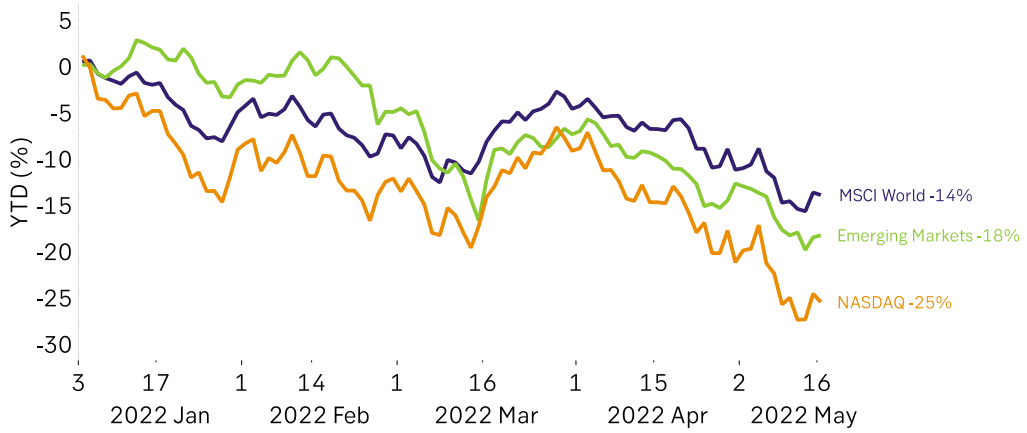
Equity and bond markets have tumbled due to concerns about rising interest rates, slowing economic growth and lockdowns in China

The combination of rising interest rates from global central banks together with worries of a slower economic recovery due to sustained inflation and persistent lockdowns in China, have turned markets downward. Despite a better than expected first quarter earnings season and decent macro data in the western world, the hawkish moves from global central banks have kept markets depressed. Bond yields have swiftly moved higher as markets expect rates to quickly rise which caused a steep sell-off in bond markets. The latest wage data in the US added to the worries of persistent inflation which led to the US 10Y yield touching at 3%. Accordingly, the tech-heavy Nasdaq index entered a bear market territory. The latest inflation prints disappointed to the downside which increased the worries that inflation can remain higher for some time. Valuations are trading much lower now as the market volatility has remained elevated. Commodity markets remained elevated with oil prices moving swiftly. Covid lockdowns in China have exacerbated the situation and driven Asian markets lower. As the market has been on a risk-off move we have also seen an upswing in the dollar.

Global central banks are hiking rates: The Fed raised its policy rate by 50 bps and projected it would raise twice more with the same amount

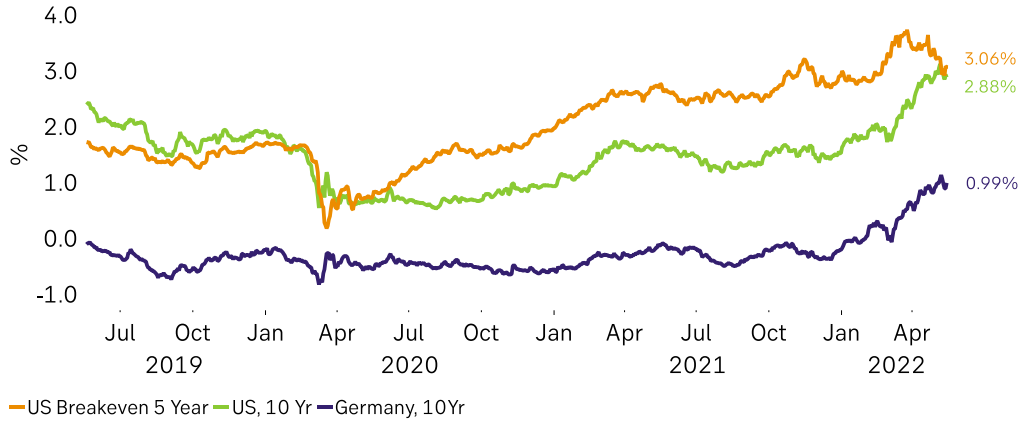
In light of the signs that inflation is broadening and a tight labour market, Fed officials decided to lift the target range to 0.75%-1%. Futures markets expect the Fed's policy rate to reach 2.75% by the end of the year from today's 0.75%-1%. The remarks from the Chairman stated that the economy has a good chance of a soft landing, but cannot rule out that it enters a recession. Especially as he noted that there are factors outside the banks control, such as supply-chain constraints. The Fed will also start to reduce its balance sheet in June. The ECB also signalled that it would raise its main interest rate in July and to end quantitative easing by Q3. The war in Ukraine has added to the worries that inflation may stay higher for longer. The Bank of England also rose its main policy rate with a quarter point to 1% and warned that the UK would slide into a recession

Figure 1: Global equities have dropped since April due to concerns about rising rates and worries of slowing economic growth. Tech-heavy Nasdaq index saw the strongest sell-off



Source: Macrobond, SEB

Figure 2: 10Y yields have risen quickly as the FED cemented its rapid rate path and the start of QT. At the same time we have seen a rollover in inflation expectations



Source: Macrobond, SEB

Economy – Developed Markets

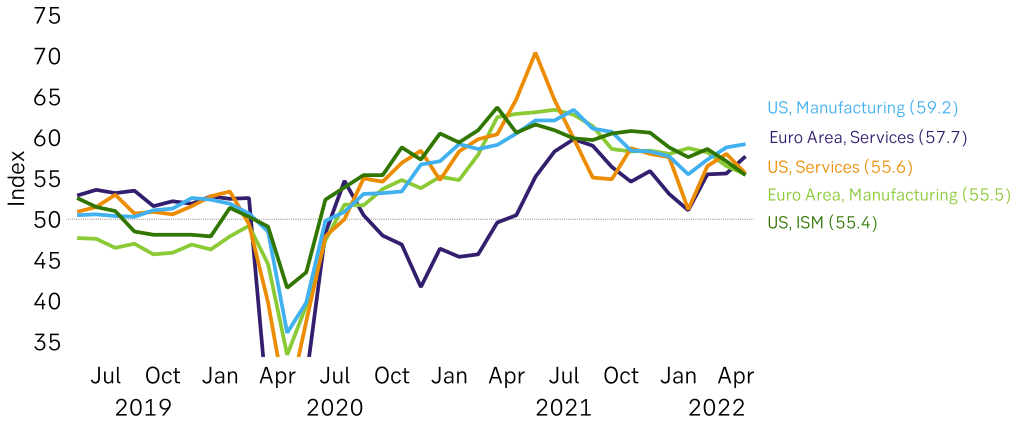
US economy in expansion but inflation MoM remains elevated

- US headline inflation YoY slightly fell in April, but stayed at elevated levels and surprised to the upside, signaling that Fed may need to keep hiking rates quickly
  - Core CPI MoM, ex volatile food and energy prices, rose more than economists had hoped for, signaling that inflation could stay higher for longer
- The Fed raised rates by 50 bps in April and signaled that balance sheet reduction will start next month, in line with expectations, as it tries to cool inflation down
  - Powell ruled out future 75 bps hikes, easing fears of Fed making a policy mistake
- ISM manufacturing and services fell more than expected in April, but remained above 50 indicating that the US economy is still expanding
  - Manufacturing is in a demand-driven and supply-constrained environment
    - The supply-side was mixed, as supply deliveries and employment components deteriorated, while prices paid by manufacturers grew at a slower pace
    - New orders, production and backlogs growth fell, customer inventories rose
- Consumer sentiment remains at depressed levels as consumers expect prices will rise at an annual pace of 3% over the next five to 10 years
  - Americans are more worried as they expect inflation can outpace their incomes
- However, the US labor market is persistently strong and added more jobs in April
  - Leisure and hospitality, previously worst hit by the pandemic, led the job gains
  - Average hourly earnings rose, less than a month ago, taking off inflation pressure
  - The participation rate declined and is still below pre-pandemic levels, possibly due to people staying at home to care for their children and elders

The war in Ukraine weighs on EU confidence and inflation

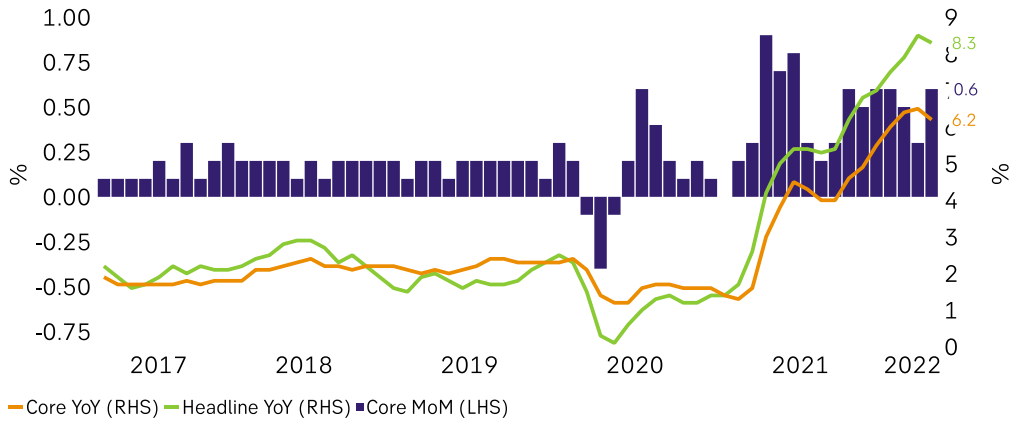
- EU macro data surprised to the downside in April, as consumer confidence fell
- Lagarde has signaled that the ECB may raise rates in July, after QE ends in June
  - ECB must balance both inflation and growth risks, as EU inflation rose to new records in April and output in the region barely grew last quarter

Figure 1: US ISM and Markit's PMI diverged in direction the last month, but overall levels are expansionary. In Europe, services PMI increased while manufacturing fell



Source: Macrobond, SEB

Figure 2: Both headline and core US inflation remained at elevated levels, but we may have passed peak levels. However, MoM Core numbers signals a broadening of inflation



Source: Macrobond, SEB

Economy – Emerging Markets

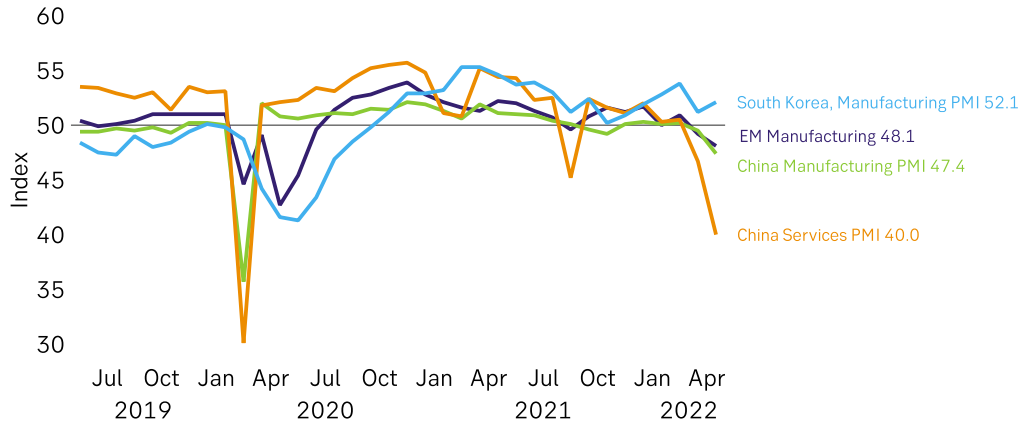
The entire region faces headwinds from China's zero-Covid policy and stronger USD

- Inflation is currently above central banks' targets everywhere, which has led every country to hike rates, except China that is easing its policy
- Food inflation, resulting from disruptions in grain production and exports due to the war in Ukraine, have led to severe risks for EM countries, especially poorer ones, where food is a large part of consumption
- Countries in the region also face threats to growth from China's zero-Covid policy and the war in Ukraine
  - Covid restrictions in China impacts the rest of the region through trade, in particular South Korea and Taiwan are most exposed to them
- EM currencies have sold off versus the USD, mostly due to interest rate differentials between US and local rates in the region
- Commodity-exporting countries have YTD benefited from rising commodity prices and will likely continue to do so as commodity prices remain elevated

Zero-Covid policy challenges China's growth target

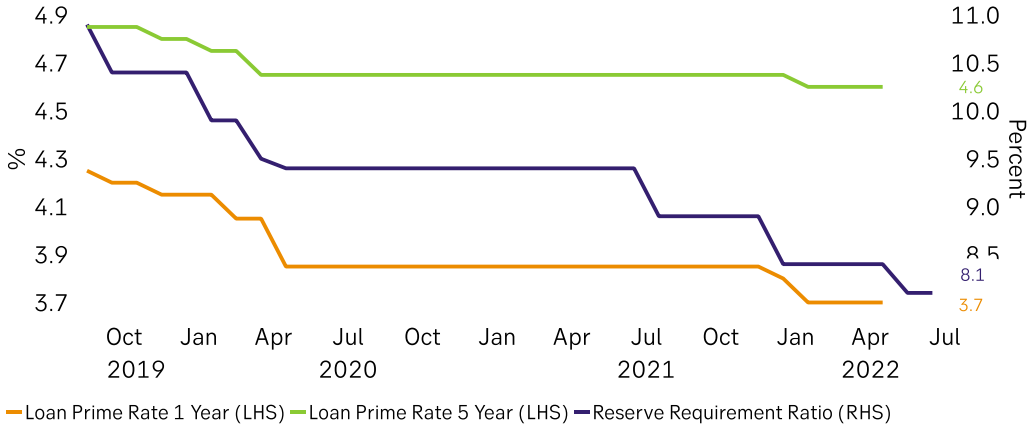
- Official and Caixin/Markit PMI showed that the manufacturing and services sectors fell into contraction due to China's zero-Covid policy
  - Activity in the service sector was particularly dented from the restrictions
- The Politburo committee meeting in April sent a clear message that China will maintain its zero-Covid policy, despite the downside risks to both demand and growth
  - The government announced that it will invest more in infrastructure to stimulate growth, likely taking on debt in order to reach its 5.5% growth target for 2022
    - China has injected liquidity into the financial system by cutting RRR rates this year, and could also cut policy rates to counteract the slowdown in growth
- Both consumer and producer price inflation were higher than expected in April
  - Consumer prices rose as restocking demand picked up amid restrictions, but inflation is still below the central bank's 3% CPI target for this year

Figure 1: Economic activity in China softened further in April, in particular the service sector was hit by lockdowns, as the country maintains its zero-Covid policy



Source: Macrobond, SEB

Figure 2: China has kept its loan primary rates steady since January this year, but rates are likely to go lower after cut in RRR in an effort to support the economy



Source: Macrobond, SEB

Overview

House View factors

Macro and Markets

Market and Fair Value Indicators

In Focus

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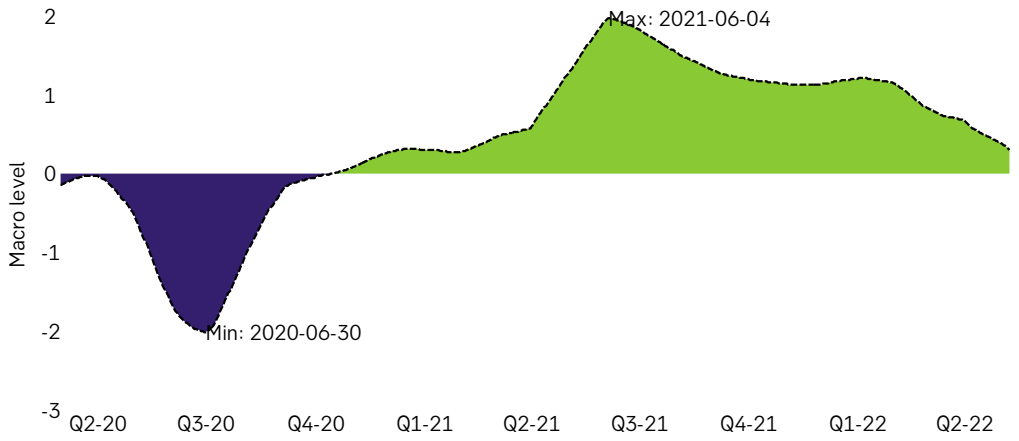
SEB House View – US Macro Status

Overall macro data is still solid despite slower momentum

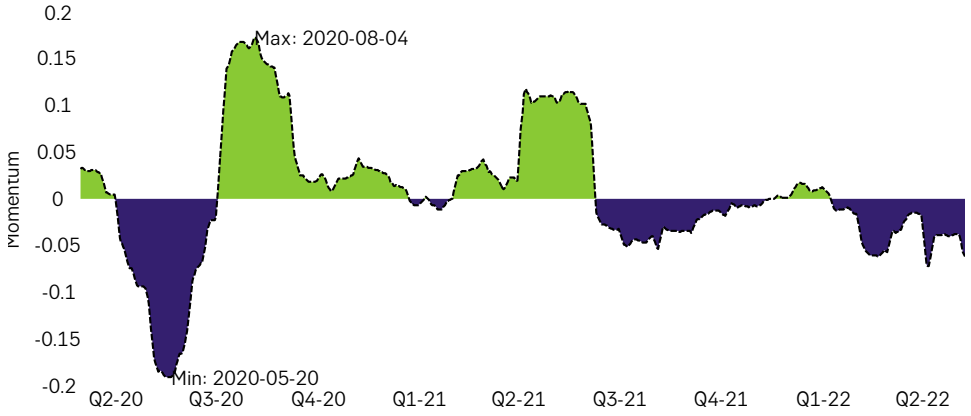
- April's ISM for manufacturing and services signaled a deceleration of business activity
  - Demand side indicators weakened as new orders moderated in combination with softer employment and production figures
  - Supply-side indicators showed that constraints have yet not let-up as supplier deliveries worsened and input prices ticked higher
- However, the labor market remains strong and tight as the impact from Covid continues to recede
- Consumption remained at high levels, despite a slowdown in retail sales
  - Households balance sheets are still at healthy levels, even if personal income
  - Nominal spending increased over the month, particularly within the service sector
    - However, real spending continued to show inflation affecting consumption
- Core inflation for April showed an acceleration of 0.6% MoM and surprising to the upside, signaling that inflation may stay higher for longer than expected

Figure 1: US macro level is still positive, but overall level is fading



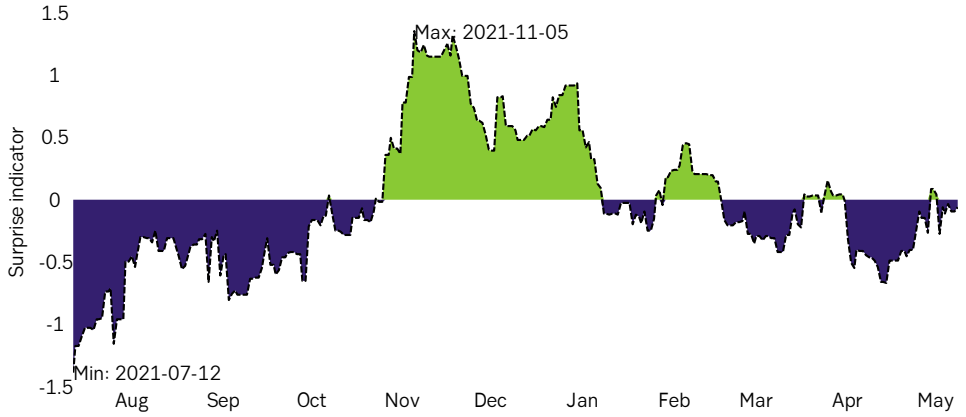
Source: SEB House View

Figure 2: Macro momentum is weaker due to lower personal income and cooler PMI:s



Source: SEB House View

Figure 3: Data has surprised to the downside, but we may see a moderation moving forward as expectations are now lower



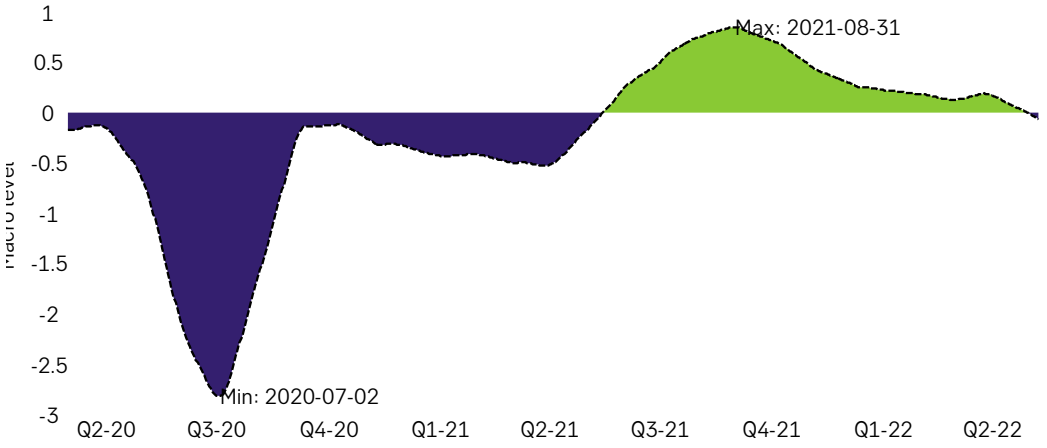
Source: SEB House View

SEB House View – EU Macro Status

Sentiment in the Euro Area faltered as growth forecasts were penciled lower and inflation estimates were revised higher

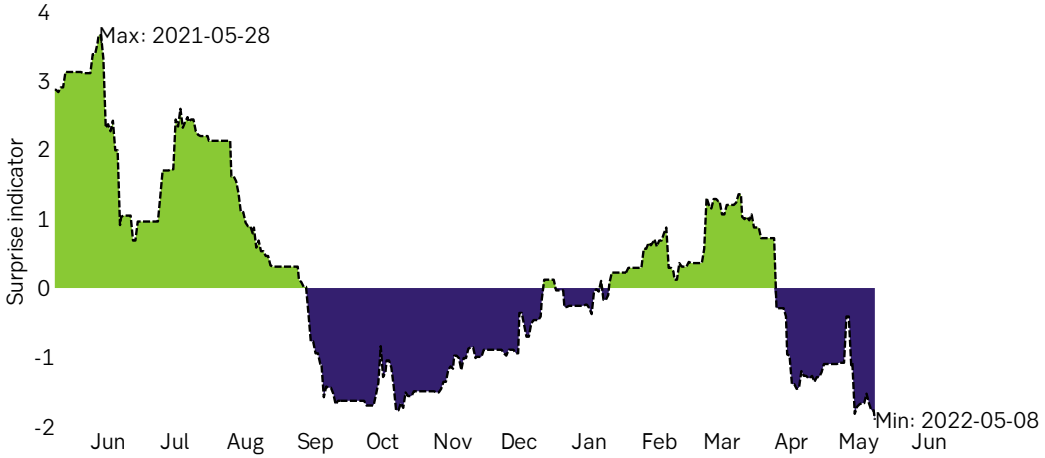
- We saw a discrepancy between business surveys in the manufacturing sector, which showed a slowdown in activity, whilst services ticked upwards as activity increased
- Business and consumer confidence worsened over the last month as the war in Ukraine exacerbates inflation and the supply disruptions in China add to the downside risks
  - Rising inflationary pressures have reduced spending power
  - Although confidence indicators remained at deeply negative territory, expectations nudged up in April signaling a lesser pessimistic view
- However, consumer spending can still post solid growth moving forward as the Covid related restrictions are increasingly being removed
- The ECB signaled that it will remove its policy support quicker than expected
  - The first rate hike was signaled to come in July, while the end of QE is expected in early Q3

Figure 1: European macro level is now at a neutral level due to weaker sentiment



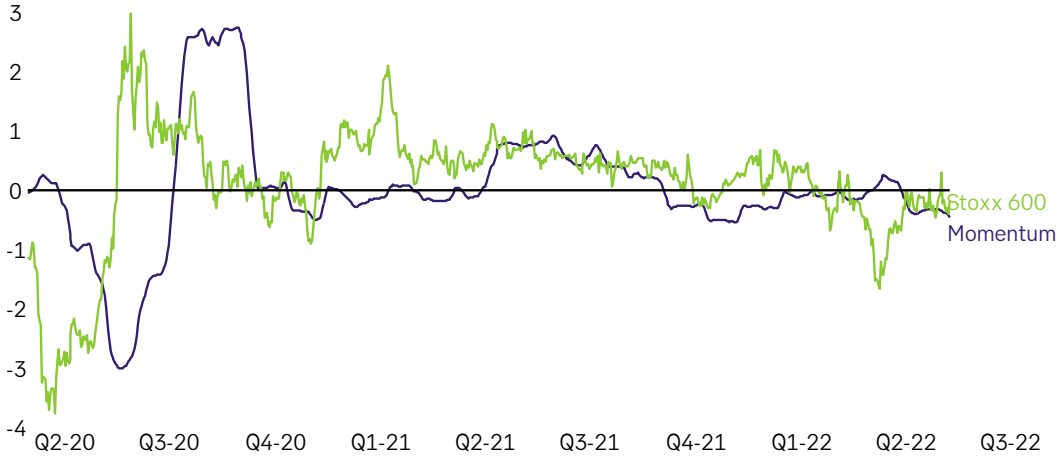
Source: SEB House View

Figure 2: Data has increasingly surprised to the downside due to weaker sentiment



Source: SEB House View

Figure 3: Momentum is fading in the region and the Stoxx 600 remains weakish



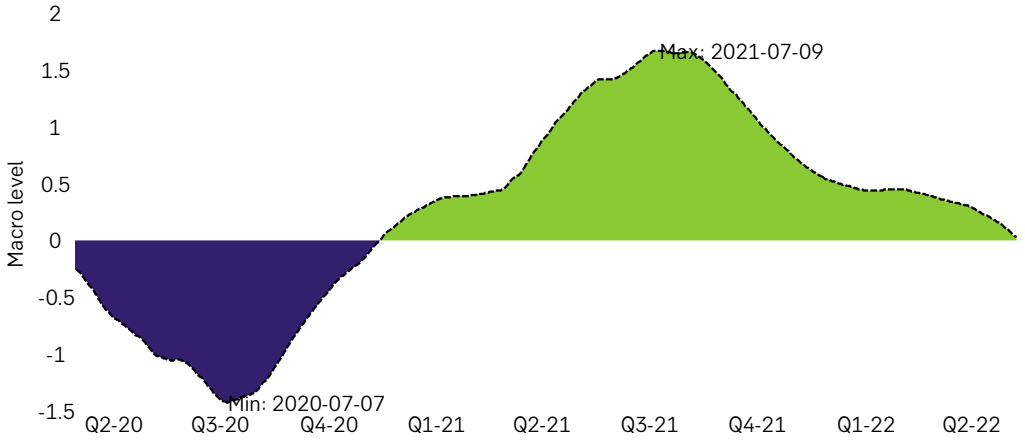
Source: SEB House View

SEB House View – EM Macro Status

EM macro data dropped in April due to renewed corona lockdowns in China

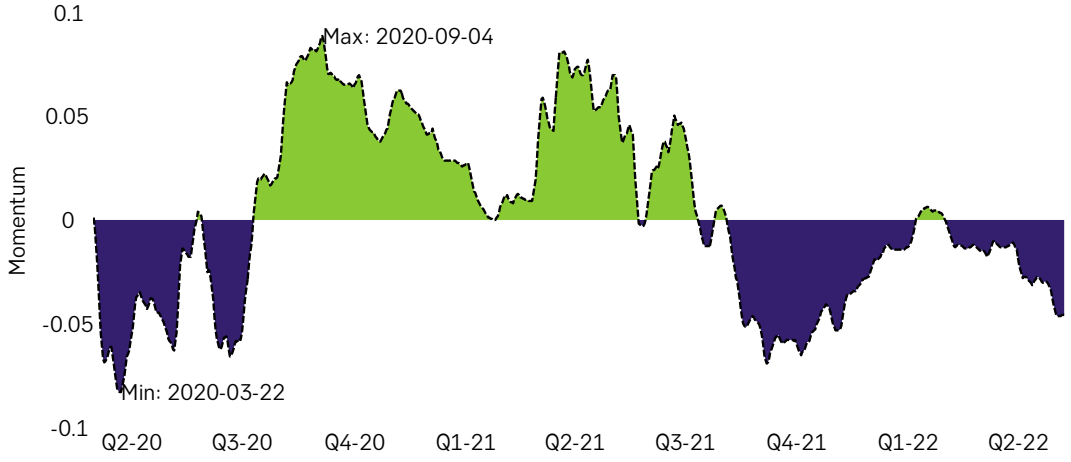
- Both manufacturing and services in China plunged to their worst level since February 2020
  - New orders and exports fell steeply signaling a negative trend for global trade
- The lockdowns are significantly impacting global supply chains as the supplier deliveries component is showing long delays to manufacturing customers
  - Downward pressures are likely to remain for the region as long as covid restrictions in Shanghai and Beijing remain in place
  - Lockdowns have also severed the labor market in China
- The PBOC will likely continue with both cuts in its RRR and lower the rate on its lending facility in order to support the economy
- Fiscal support from the government on infrastructure spending is a positive
  - But as long as lockdowns remain in place, the downside risks for the macro outlook have increased

Figure 1: EM macro level moved lower over the last month due to lockdowns in China



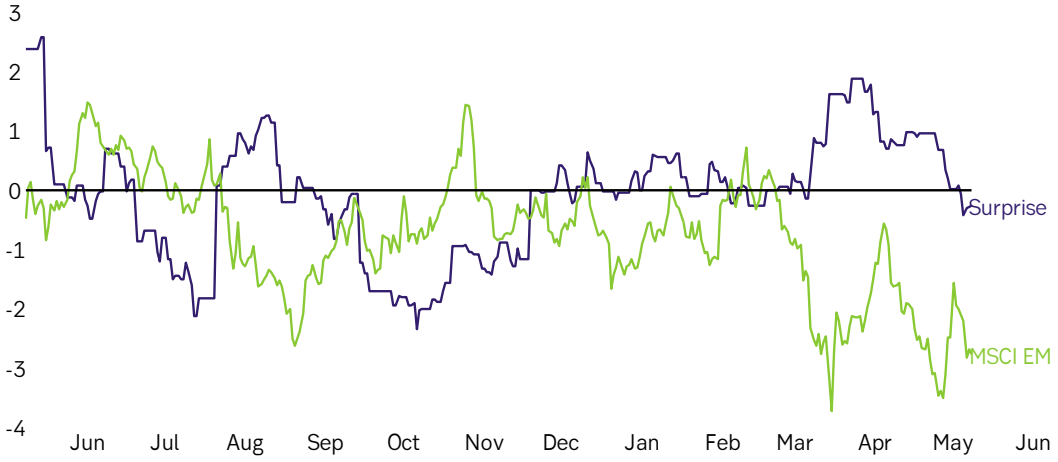
Source: SEB House View

Figure 2: Momentum turned negative due to weak economic activity from lockdowns



Source: SEB House View

Figure 3: EM macro data has lately surprised to the downside alongside with lower markets



Source: SEB House View

Overview

House View factors

Macro and Markets

Market and Fair Value Indicators

In Focus

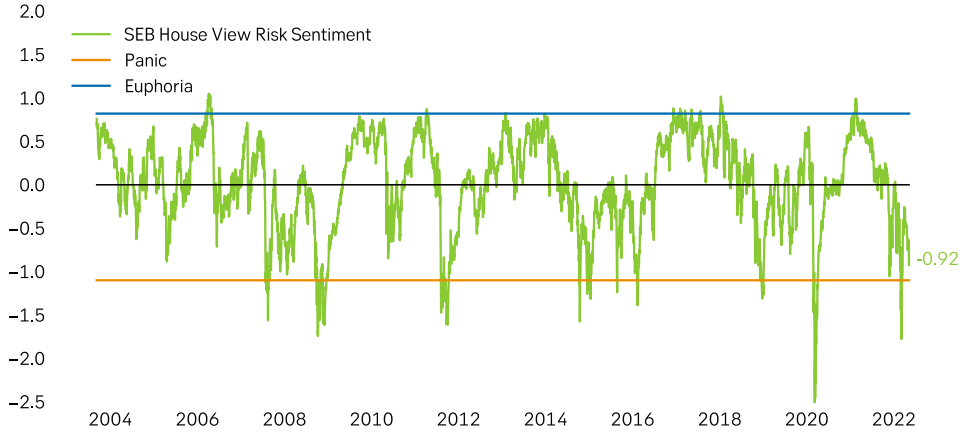
Asset Class and Sector Views

SEB House View – Risk Indicator

The Risk Indicator is close to being in panic territory, again

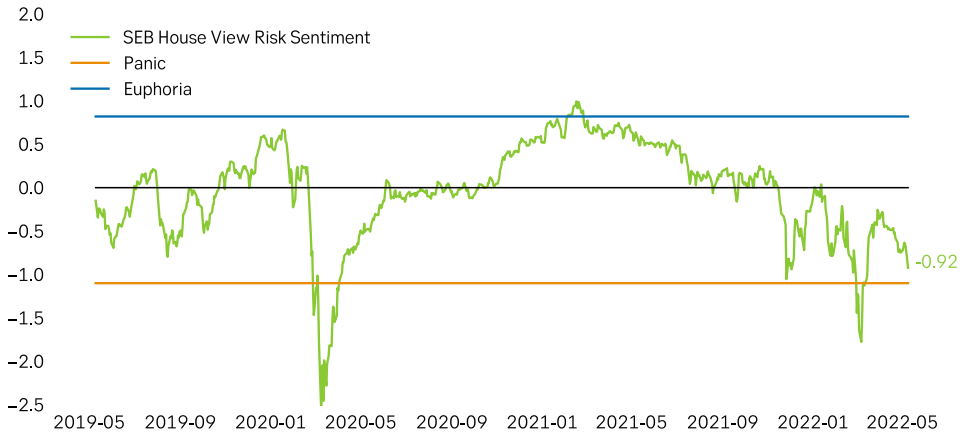
- Our risk indicator has turned more negative as aggressive tightening by the FED triggered recessionary fears and sent markets lower
  - A risk-off sentiment contributed most negatively to our risk indicator
    - Inflationary fears, coming from supply chain pressure due to China's zero-covid policy, as well as higher energy and food prices from the war in Ukraine, led to a sell-off in risky assets
  - Wider credit spreads, in both IG and HY, and higher volatility, had a negative impact on our risk indicator as well
- Our negative risk indicator signals that markets are now close to being oversold and we are therefore careful to not be too bearish
  - Much is already priced in, in terms of FED quantitative tightening, elevated inflation, the war in Ukraine and lockdowns in China, and any improvement in these areas would likely reverse the downward trend

Figure 1: SEB House View Risk Indicator



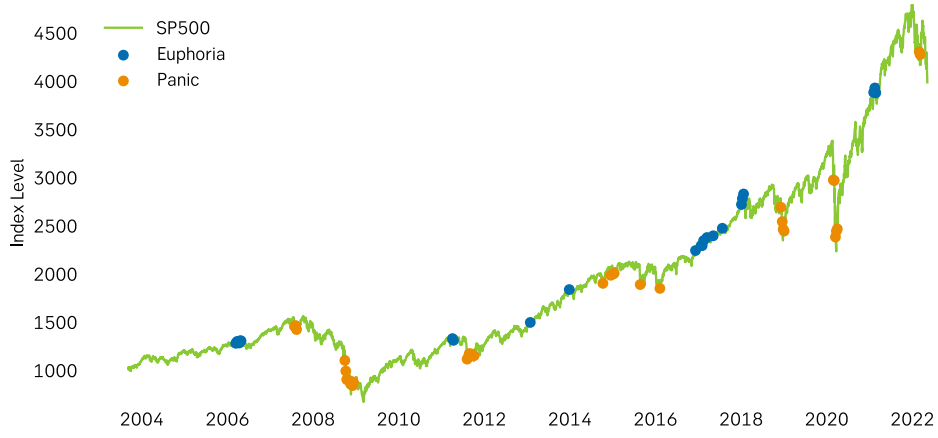
Source: SEB House View

Figure 2: SEB House View Risk Indicator – Short Time Horizon



Source: SEB House View

Figure 3: Extreme states plotted on SP500



Source: SEB House View

In Focus: Quantitative Tightening

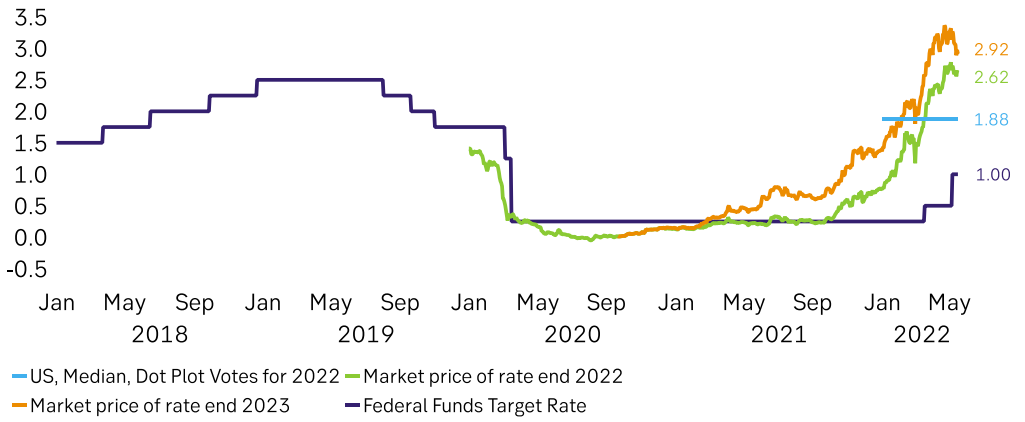
The notion that the Fed is behind the curve and will need to act aggressively to catch up with high inflation has been in focus

- The FED raised the federal funds rate by 50 bps at its last meeting and announced that it will start reducing its balance sheet next month, in line with expectations
  - High inflation, driven by the reopening, as well as energy and food prices, has caused the central bank to accelerate its policy normalization, with two more 50 bps hikes expected at its next two meetings
- Powell's message was that FED wants to tighten financial conditions and increase rates in order to bring down inflation
  - Many fear the Fed's rapid tightening amid current lockdowns in China, supply chains pressure and the war in Ukraine, will be a policy mistake as it could more easily cause a recession
  - The Fed is confident that it can manage a soft landing despite aggressive tightening, given the tight labor market and strong economy

The Fed will likely be data-driven, like it has been in the past

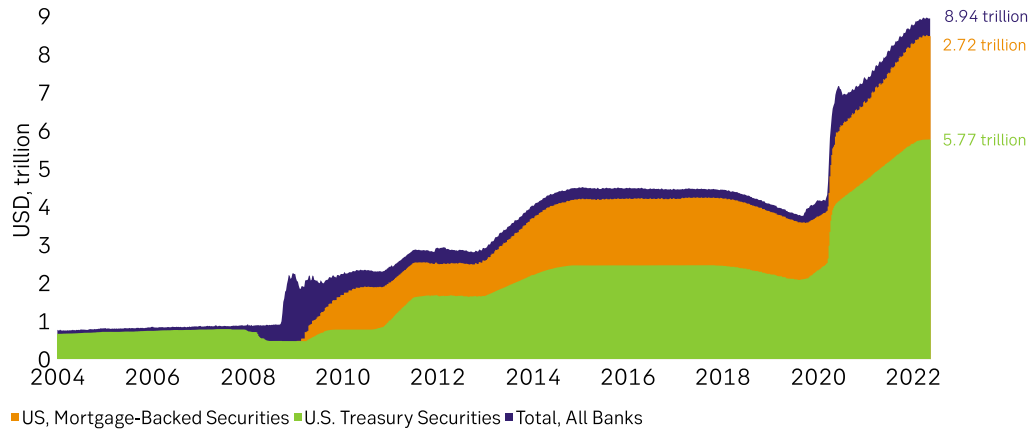
- The Fed will most likely be data-dependent and closely follow economic developments for clues on how to adjust its policy going forward
  - The last US tightening cycle abruptly ended in 2019, due to negative market reactions when global growth slowed and the US-China trade war escalated, which in turn prompted the Fed to pause rate hikes and subsequently cut rates
  - Policy adjustments will probably be different this time and the Fed more likely to pause hikes than cut rates, as we have above-trend growth and elevated inflation
  - Paused rate hikes would be a positive trigger for markets, however, it is likely too early for that given the slow moderation in inflation in April
- The Fed will monitor developments in the labor market and how it holds up
  - Slower wage and job growth in April compared with previous months may be an early sign that the labor market is cooling down
  - Higher living costs from food and energy will likely force more people back to the labor force, increasing the participation rate and reducing wage inflation

Figure 1: According to the March dot plot meeting, the median rate at the end of 2022 is at 1.9%, whilst the market is currently pricing in at least 7 more 25 bps hikes



Source: Macrobond, SEB

Figure 2: The Fed plans to reduce its balance sheet, which was built up during the pandemic, by an initial monthly pace of $47.5 billion from June



Source: Macrobond, SEB

Overview

House View factors

Macro and Markets

Market and Fair Value Indicators

In Focus

Asset Class and Sector Views

Developed Market Equities – 12M Outlook

Our 12 month outlook for developed market equities is now much more uncertain due to the augmented headwinds, but over a tactical horizon we expect that equities can still outperform government bonds

The downside risks stemming from prolonged elevated inflation has risen the uncertainty for markets. We have seen downward revisions in GDP forecasts which are taking the new inflationary environment into account. However, the risk of a policy mistake from the Fed and continued lockdowns in China are increasing the downside risks for equities. Having said that, we also see that too much bearishness is currently priced into the markets as positioning and valuations are quite low. Moreover, looking at the glass half-full, the US economy remains robust with strong households and businesses. We also acknowledge that we could see a turnaround in China's zero-covid policy, easing in supply constraints and an end to the war in Ukraine which could ease inflation ahead.

However, as rates rise, the TINA argument can now be retired

With rates still set to rise from here government bonds are for now deemed to be out of favor. But we are closing in on levels where it may be interesting to move capital from the equity market to the bond market.

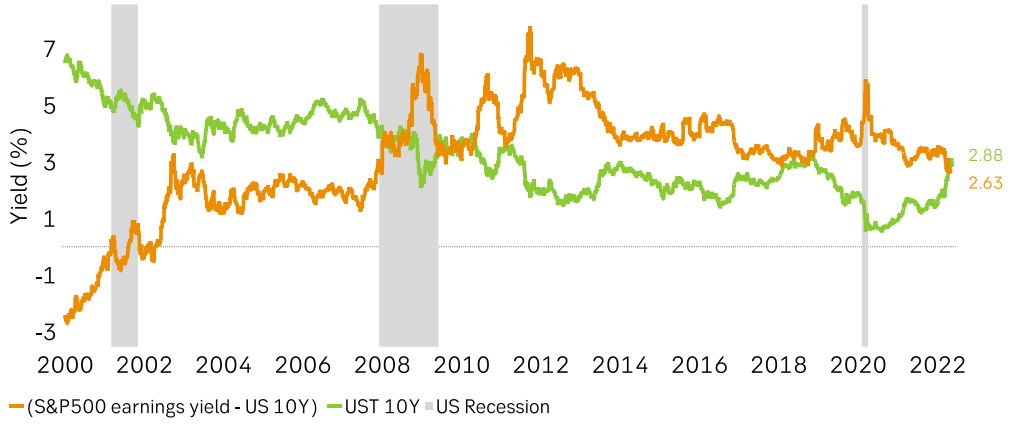
Companies that can raise prices despite inflationary pressures and maintain good profit margins will be the winners of this new environment

As the downside risks have risen of higher-for-longer-inflation we expect that companies that can handle higher input prices to perform the strongest. The first quarter earnings season showed that overall earnings were fairly positive, despite some challenges for tech stocks.

12M Fwd P/E multiples are now trading at pre-pandemic levels

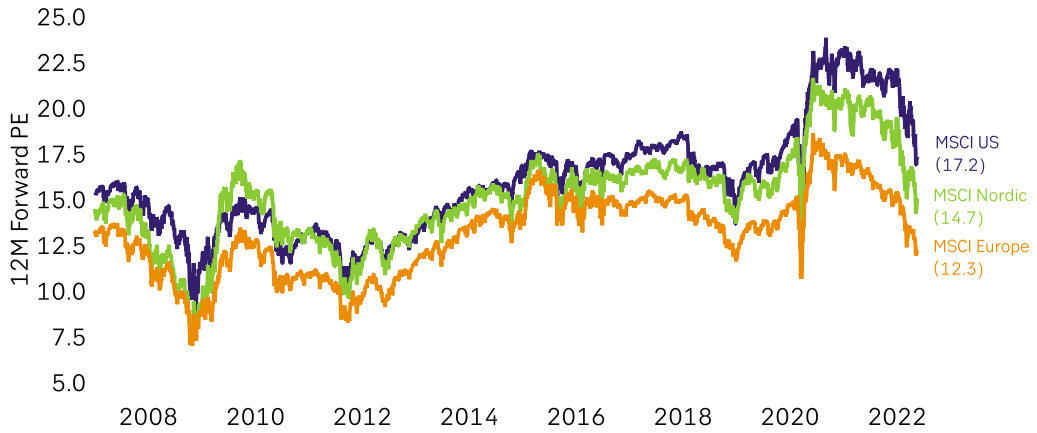
The recent downturn in markets has meant that valuations are now trading at a much more sanguine level. We could see multiples lift from here in case we see a stabilization in yields and better earnings moving forward.

Figure 1: Rising yields has dented on the potential for equities as the earnings yield is now on par with the US10Y yield



Source: Macrobond, SEB

Figure 2: Valuations have drastically fallen and are now trading at levels pre-Covid crisis



Source: Macrobond, SEB

Emerging Market Equities – 12M Outlook

We expect Emerging Market Equities to deliver positive returns over the next 12 months

The growth premium of EM markets relative to DM markets can accelerate in 2022 as inflation and commodity prices will likely remain elevated in this new evolving phase. That is, we could see an improvement of GDP in these regions and can expect further positive earnings revisions. The reopening trade is yet not fully priced in for the region and should benefit EM. However, the lockdowns in China due to Covid are still a major risk for the region. But given China's GDP goal this year, there is a chance of a turnaround on its zero-Covid policy. In our view, as long as the global economic outlook remains buoyant, we expect the asset class to outperform bonds.

Policy support in China will likely benefit the asset class for the next 12 months

We expect China to boost consumption and investments through supportive monetary and fiscal policies. The PBOC is at a different starting point than DM central banks and can support the economy with stimulating monetary and fiscal policies.

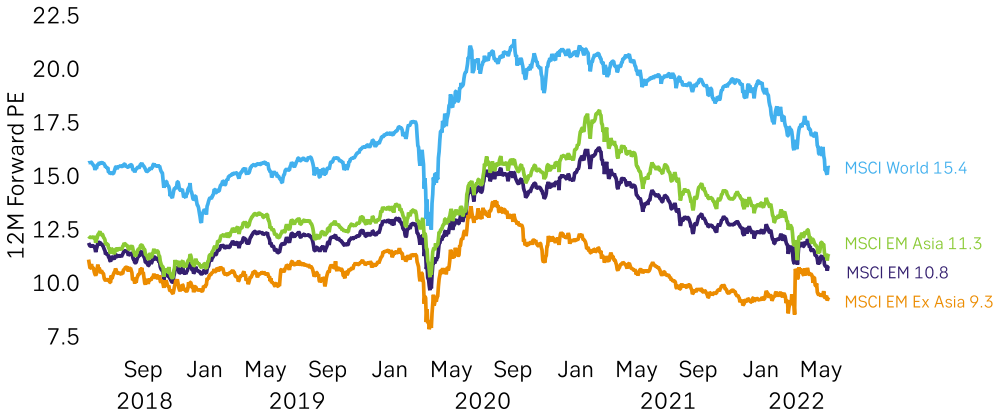
The direction of the dollar will determine the performance of EM equities

Given that US rates are expected to rise we could see further rises in the dollar which would put negative pressures on EM equities. But seeing as the dollar has reached a level we have not seen since 2002, we may have reached a peak level.

Price levels in EM equities remain attractive relative to DM equities

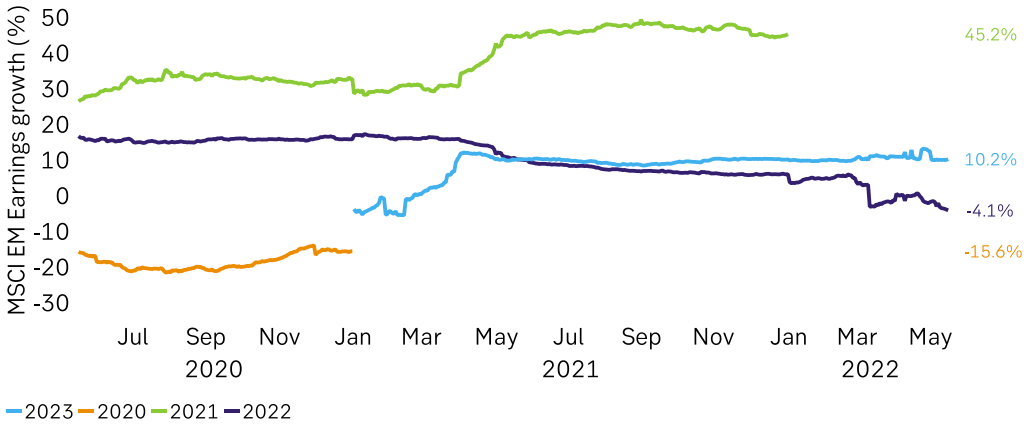
EM valuation has traded cheaper due to a multitude of challenges last year: zero Covid strategy, property sector adjustment, power rationing and a regulatory adjustment to the corporate profit share. Global investors are still relatively underweight EM due to the higher risk premia in the region, but we may see a turnaround this year as investors look for alternative assets when developed markets and bond markets are under pressure.

Figure 1: Emerging market equities can now come into favor as they are in a relatively better position to rally from here on forward than last year



Source: Macrobond, SEB

Figure 2: In our view EPS estimates for EM are too low. We expect the reopening of countries in the EM, together with strong external demand to support the asset class



Source: Macrobond, SEB

Corporate Bonds – 12M Outlook

Over a 12-month horizon we prefer Equities over High Yield bonds and Investment Grade bonds and continue to hold an underweight to these corporate bonds

The relative attractiveness of High Yield and Investment Grade bonds to equities has diminished given that risk-adjusted potential remains weak. Credit spreads have recently widened due to rising bond yields. Moving forward, spread widening is still a risk in this inflationary environment, while the risk-reward for equities is higher.

Corporate bonds can see withdrawals due to rising rates, slowing growth and escalating geopolitical tensions

Investment Grade Bonds can still offer a decent return and some protection against the volatility of stocks, but the potential has considerably decreased as duration is now longer. The risks of rising rates in combination with the uncertainty posed by the war in Ukraine can further weigh on corporate debt.

We expect credit profiles to remain stable as activity normalizes

Although corporate bonds have performed poorly since the start of the year, businesses balance sheets remain sturdy. However, we remain wary of the risks from geopolitics, prolonged inflation and a slower economic recovery

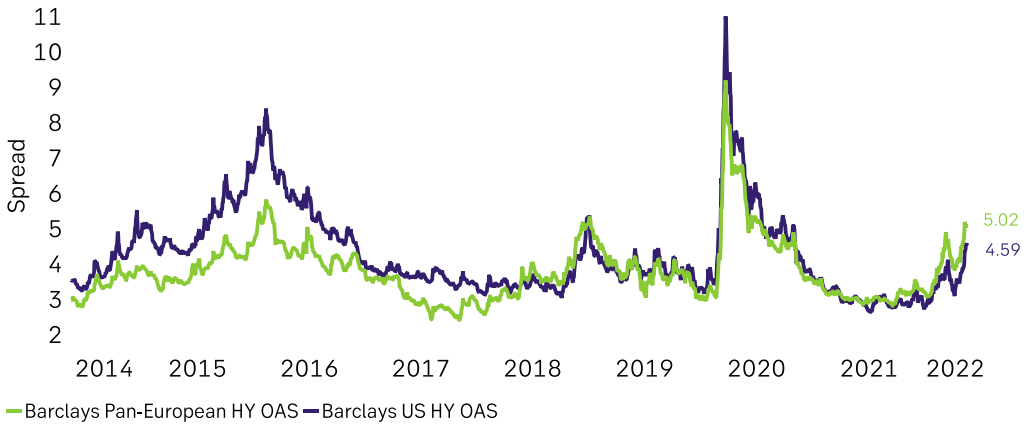
Liquidity in the market is getting more challenged

Recently we have seen financial conditions deteriorate due to a tighter monetary policy from global central banks. The US Treasury curve remains flattish as bond markets are more cautious on the outlook. And with a tightening monetary policy ahead we could see further volatility in bond markets onwards.

Nevertheless, we expect default rates to stay low moving forward

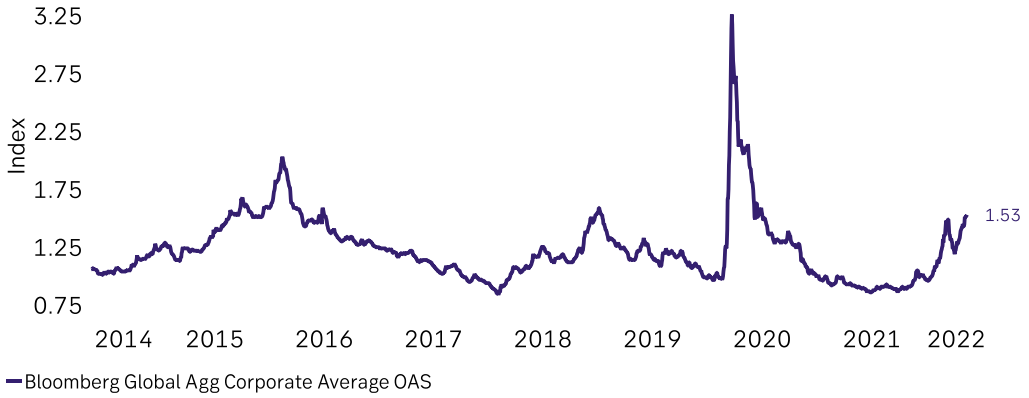
We expect it is unlikely that default risks will be priced aggressively as business have strong balance sheets. However, we note that with elevated inflation the downside risks have increased

Figure 1: HY spreads continued to widen in US and Europe as bond yields rose. In our view there is still further risks of spread widening at this point in time



Source: Macrobond, SEB

Figure 2: The spread on Investment Grade bonds also rose as the corporate bond market priced in further uncertainty



Source: Macrobond, SEB

Government Bonds – 12M Outlook

We hold an underweight to Government Bonds in favor of Equities

Markets are expecting the Fed to hike rates aggressively in 2022 and to continue its hiking path in 2023. Over the next 12 months we expect the yield curve to continue its shift upwards as central banks hike rates and implement quantitative tightening. Having said that, treasury yields are likely to remain at overall low levels in comparison to long-term historical perspective. So given the low yields and expected trajectory of bond yields, the asset class provides less risk diversification potential in the portfolio than previously held.

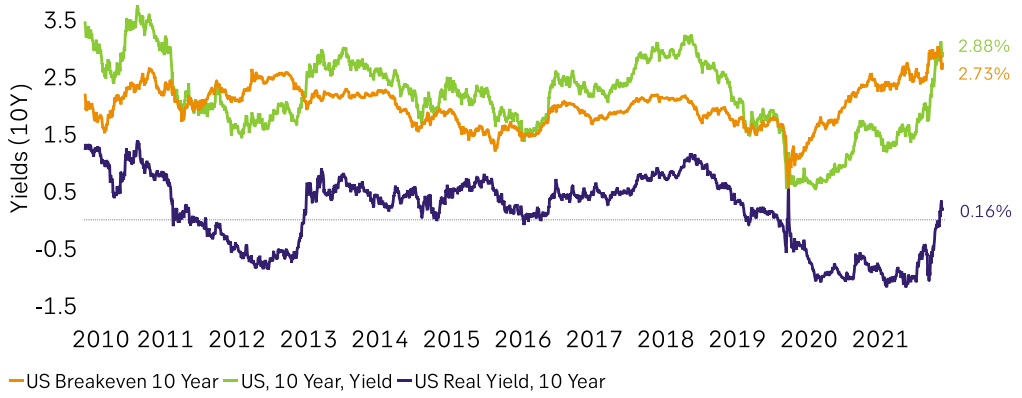
Real yields have turned positive due to the rapid rise in yields

The US yield curve has continued its shift upwards over the last month as markets priced in a rapid tightening of monetary policy. Inflation breakeven have moved downwards as central banks are now focused on battling inflation, but also because markets are more worried about the economic outlook. Given these moves, we have seen real yields rise and close in on positive levels. A rise in real yields should be beneficial for markets. But while a gradual rise in real yields reflects the fact that the economy is improving, a fast rise in real yields may spark volatility for equity investors. However, real yields are still at low levels which will likely keep a lid on the potential return for government bonds.

Over the long-term government yields will remained capped due to increased fiscal debt in developed markets

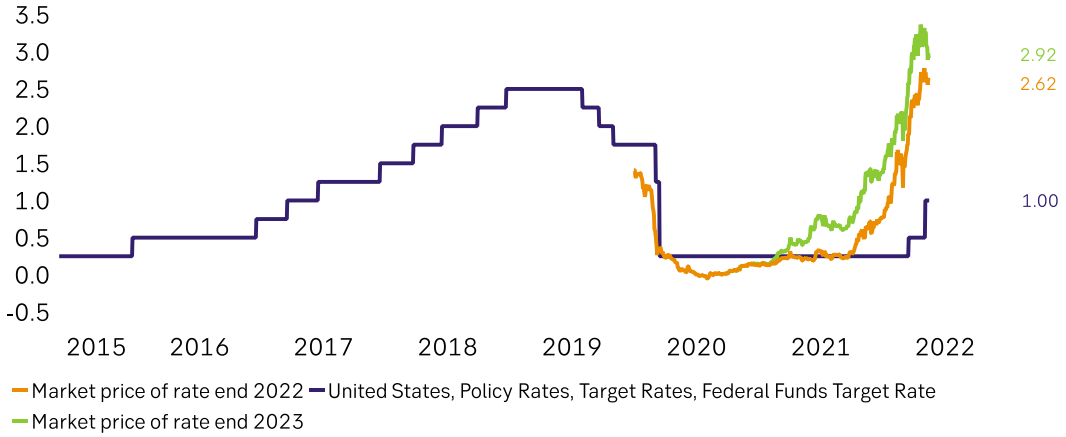
The enormous monetary and fiscal stimulus has allowed for central banks and governments balance sheets to balloon. Therefore, in order to fund the current national debt levels governments are likely to maintain interest rates at low levels for a very long time. We could also see an increase in taxes in order to reduce debt levels, but a hike in tax rates or cuts in government expenditure are not very likely in the near term.

Figure 1: Real yields have moved into positive territory. Treasuries are still under pressure as rates are expected to rise, but levels are getting more attractive



Source: Macrobond, SEB

Figure 2: Markets are pricing in several more hikes for 2022 to obtain a year end rate that we have not seen since 2019



Source: Macrobond, SEB

Region Overview

Regional equity positioning

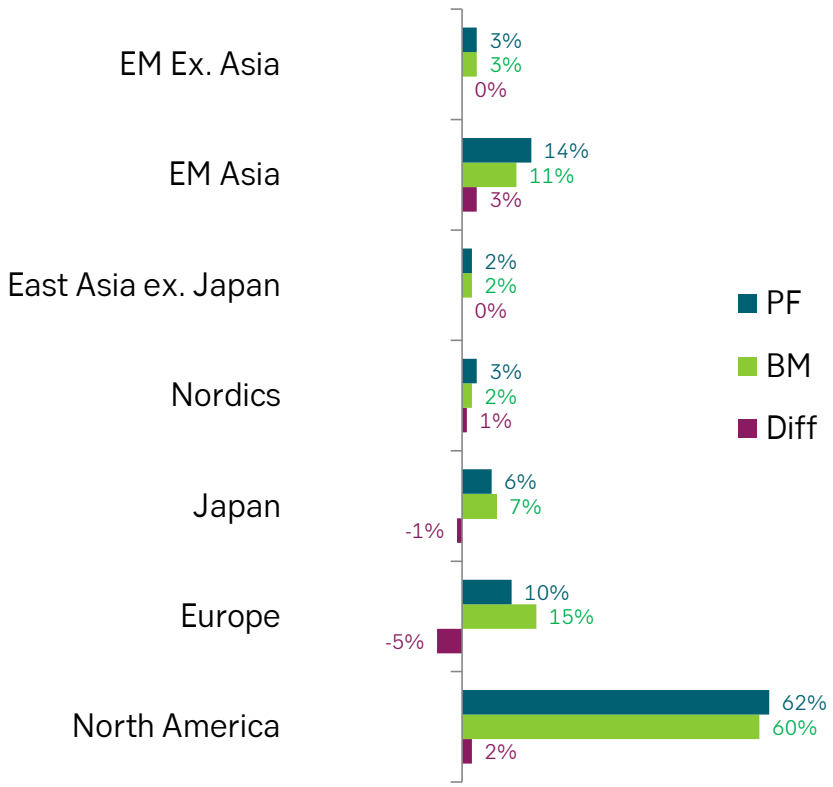
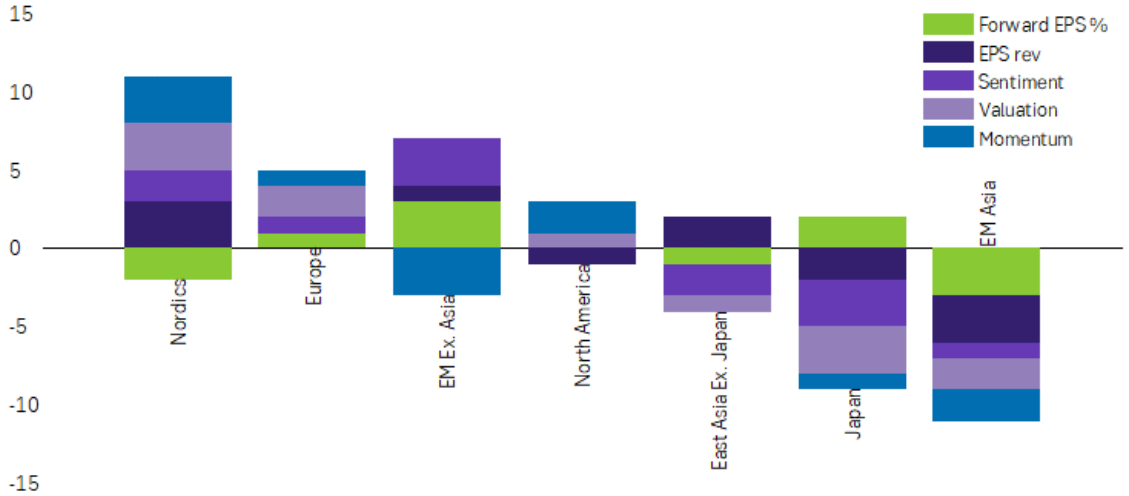


Figure 1: SEB House View region score*



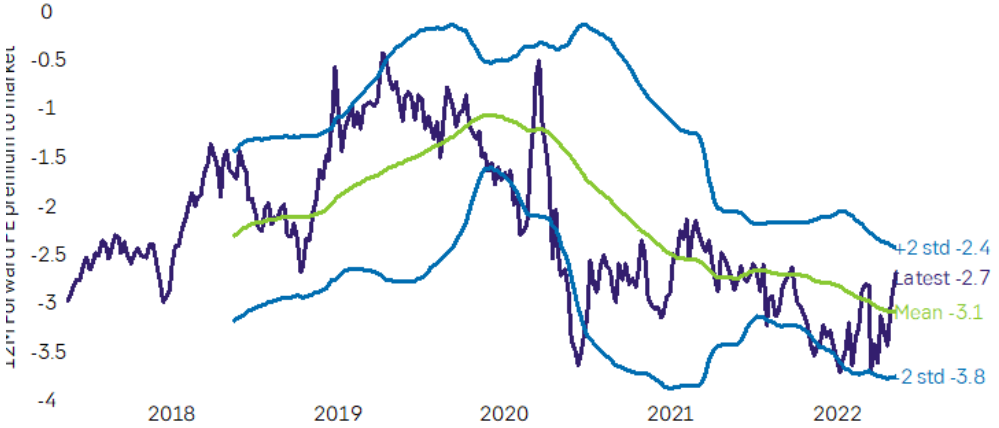
* Ranked by total score with highest score starting from left

EM Asia – Overweight

Covid restrictions continue to slow economic activity in China, but with all negative sentiment already discounted by markets, there is a potential for positive surprises

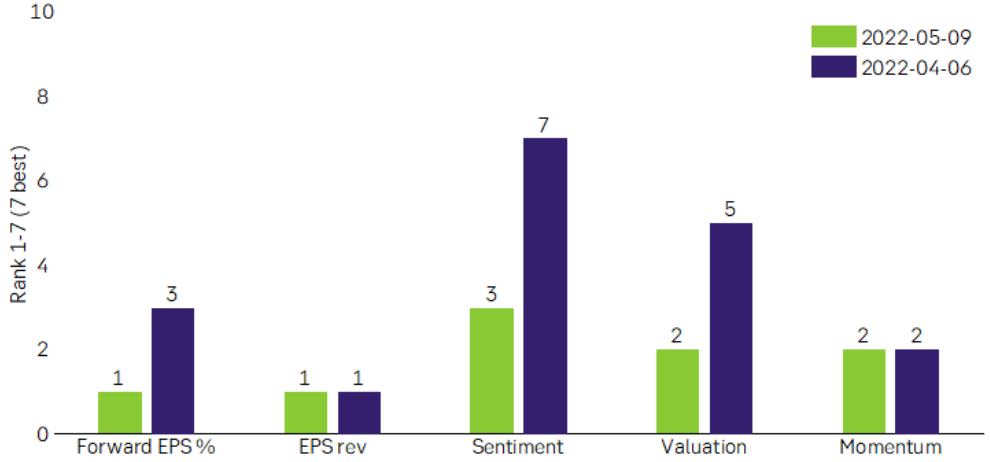
- April's Politburo meeting stated that China will maintain its zero-Covid policy, but it also signaled increased stimulus, which should further increase credit impulse
- China's official manufacturing and services PMIs fell deeper into contraction territory in April from the previous month, due to draconian lockdowns across the country
  - On the bright side, earlier fiscal and policy stimulus have probably not kicked in yet and new infrastructure stimulus should support economic activity in the near-term
  - The latest PMIs highlight the economic cost of its zero-Covid policy and further increases the pressure on president Xi from his own party to deliver growth
    - China will likely have to adjust its policy this year, strengthen its vaccine development or start to import more effective vaccines from the West
    - Asian equities would likely have the most to gain from a policy adjustment

Figure 1: Standardized relative valuation – Current constituents



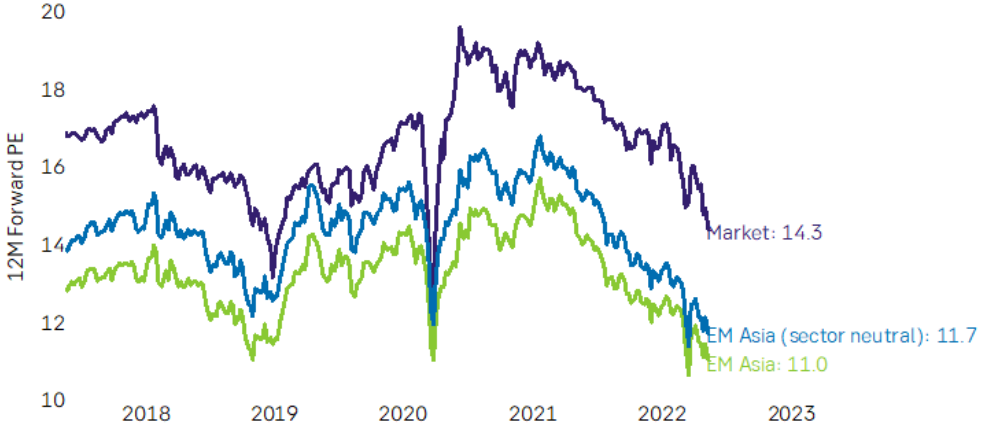
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



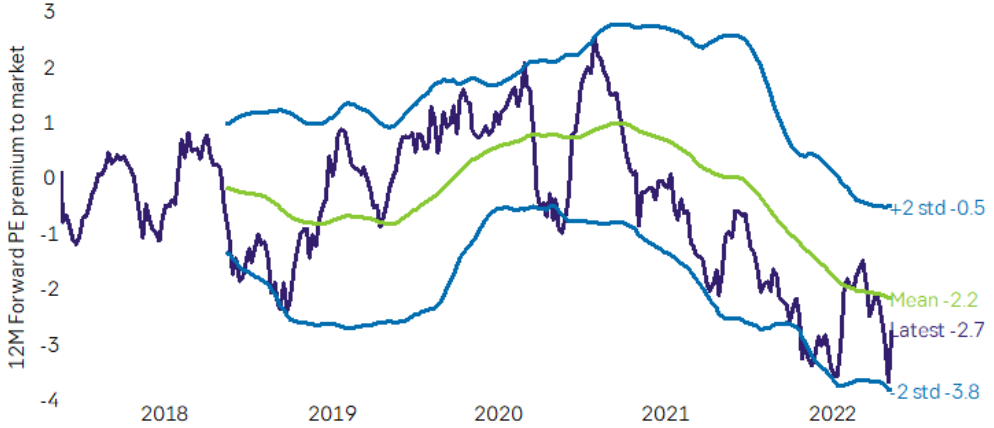
Source: SEB House View

EM Ex Asia – Neutral

EM ex Asia should

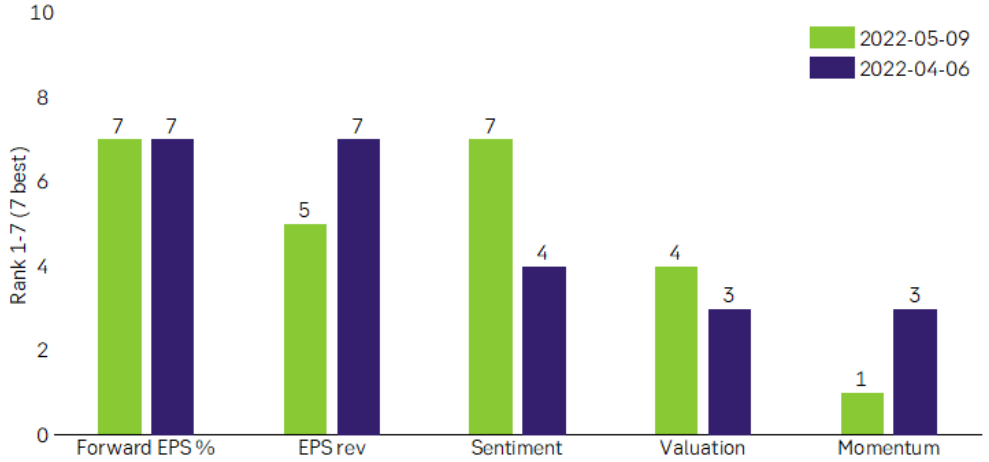
- Inflation in EM has surprised to the upside, which will likely force EM central banks to increase their pace of normalization, which should drag growth in the region lower
- Higher food prices from the war in Ukraine will likely hit consumers in EM more than in other regions, since food items makes up a larger proportion of their expenditures
  - Food inflation will likely persist given that supply issues with Russia and Ukraine, which are both major exporters, continues due to the conflict
- Fed's interest rate path will likely lead to several headwinds for this region
  - Higher rates could strengthen the USD and make sovereign debt more expensive for EM governments and companies to service
  - EM countries will probably see capital outflows from higher US rates
- However, forward earnings growth in EM is higher than in other regions and equities looks oversold based on our sentiment indicator

Figure 1: Standardized relative valuation – Current constituents



Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents

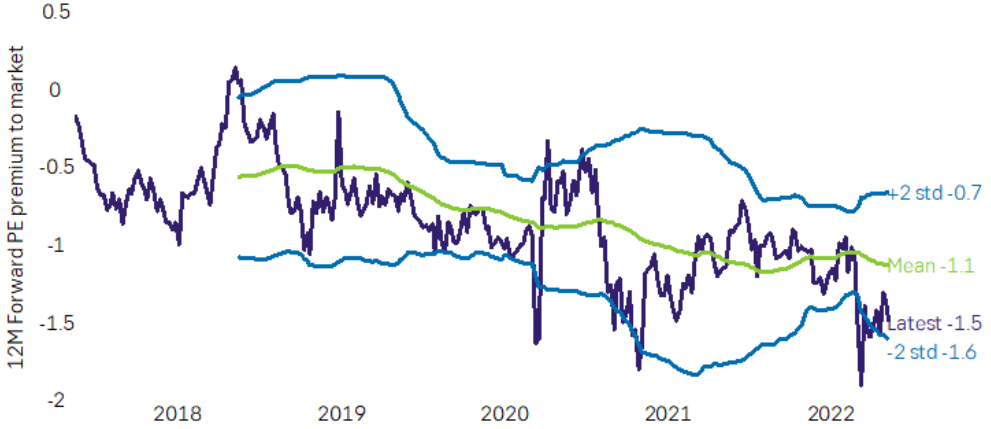
Source: SEB House View

Europe – Underweight

Starting QT increases risk of stagflation as growth is already weakened

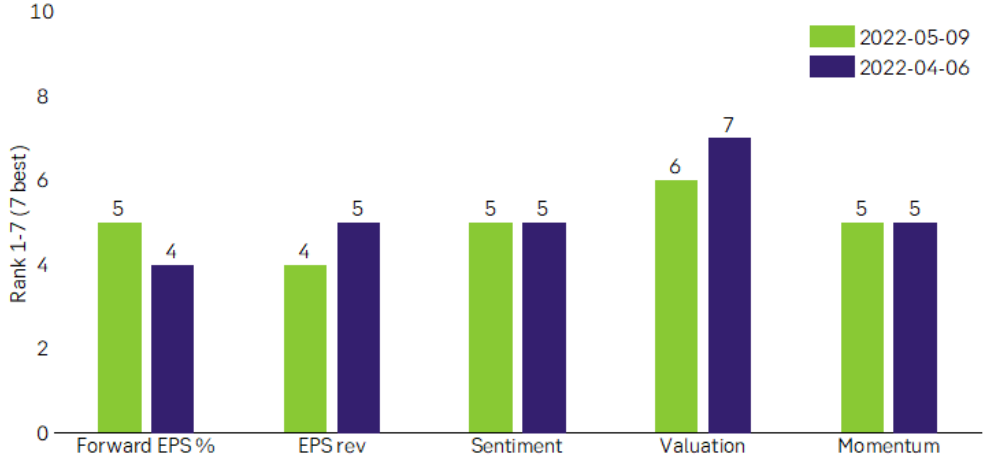
- The ECB may begin tightening its monetary policy weeks after QE ends
  - Net bond-buying is expected to end in June and President Lagarde has signaled that it may raise rates for the first time since 2011 at its July meeting
  - The ECB is lagging BoE and Fed, which has already started policy normalization, despite record inflation in the EU in April, well above its target
- There is a more direct negative impact from the war in Ukraine on inflation and growth in the EU than in other regions, besides global supply chain pressure and inflation from the pandemic, which increases stagflation risks
  - There are signs that the European economy is already slowing down, with Q1 GDP growth at 0.2%, and tightening would bring growth down even more
- Valuations for European equities look attractive, both compared with other regions and its own history

Figure 1: Standardized relative valuation – Current constituents



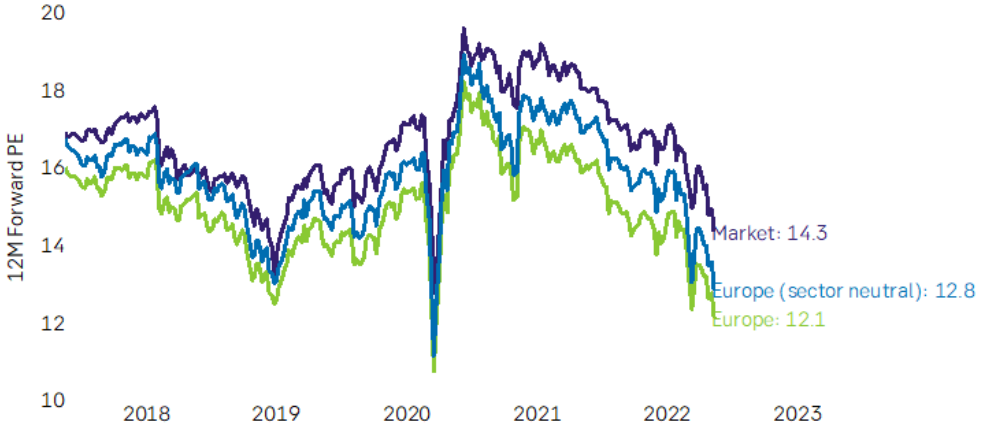
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



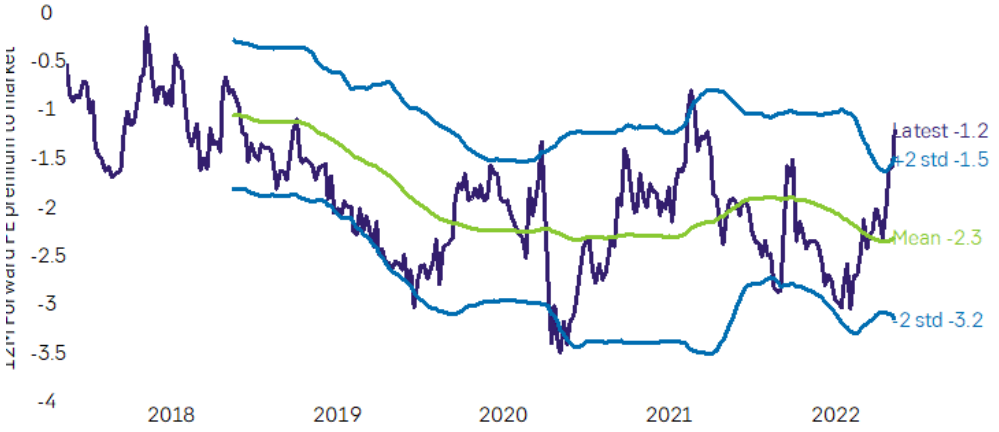
Source: SEB House View

Japan – Underweight

The Japanese economy likely contracted in Q1 on the back of falling consumption

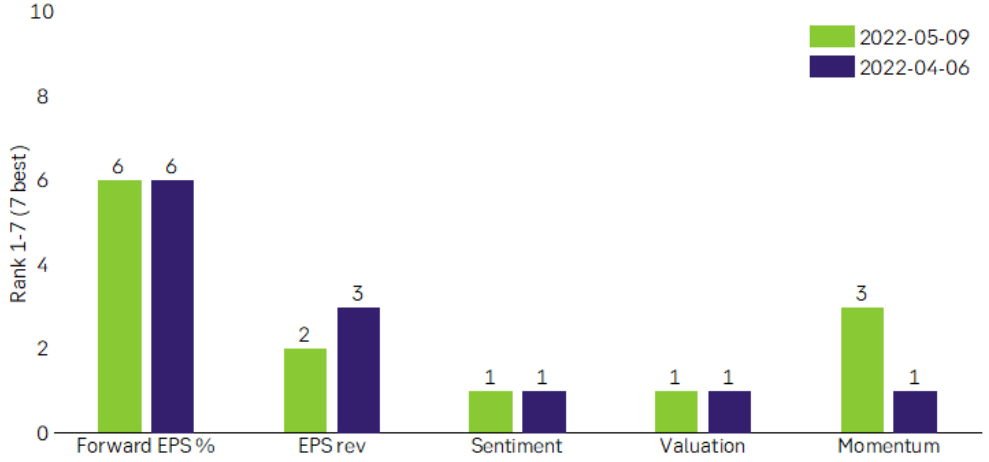
- Japan lifted its covid restrictions in late March, leading to higher consumption
  - Household spending increased MoM for the first time this year in March, on the back of spending on transportation, communications and apparel
  - However, household spending still fell during Q1, indicating that the economy likely shrank in the first quarter due to a drop in consumption
- The Yen has weakened as the BoJ has taken a dovish policy stance and kept bond yields close to its near-zero target, in contrast with other DM central banks
  - A depreciation in the currency exacerbates the negative impact from inflation on consumer spending and import costs for firms
    - Rising prices combined with a weaker Yen will likely put a dent on consumption and limit the recovery of the Japanese economy going forward
- Nevertheless, 12M forward EPS growth looks relatively attractive

Figure 1: Standardized relative valuation – Current constituents



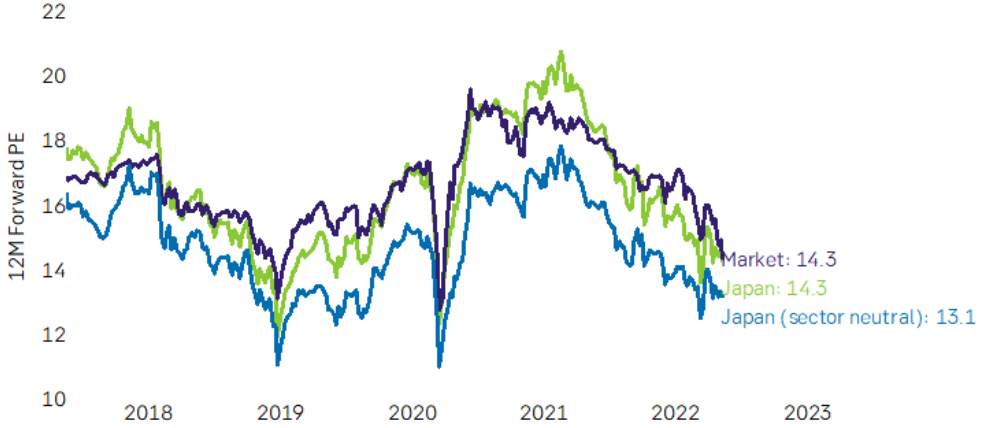
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



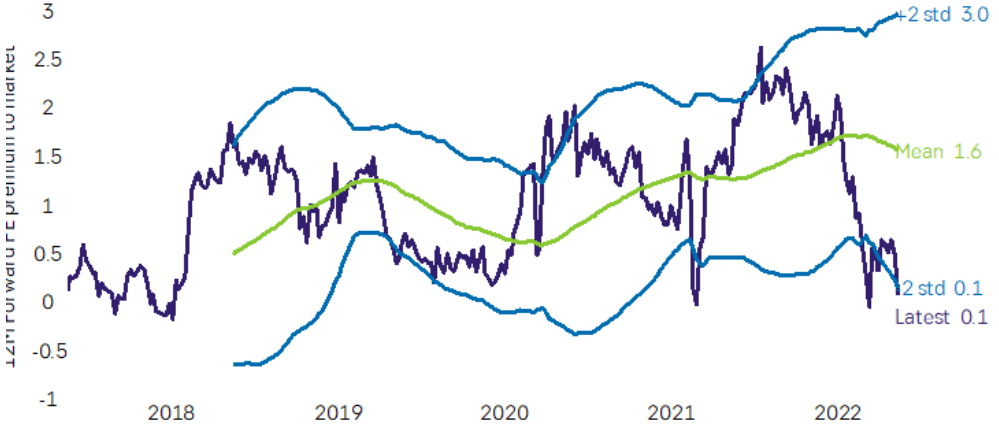
Source: SEB House View

Nordics – Overweight

Consumption will likely be sustained amid high employment, expansive fiscal policies and lower household savings, despite higher prices and rates

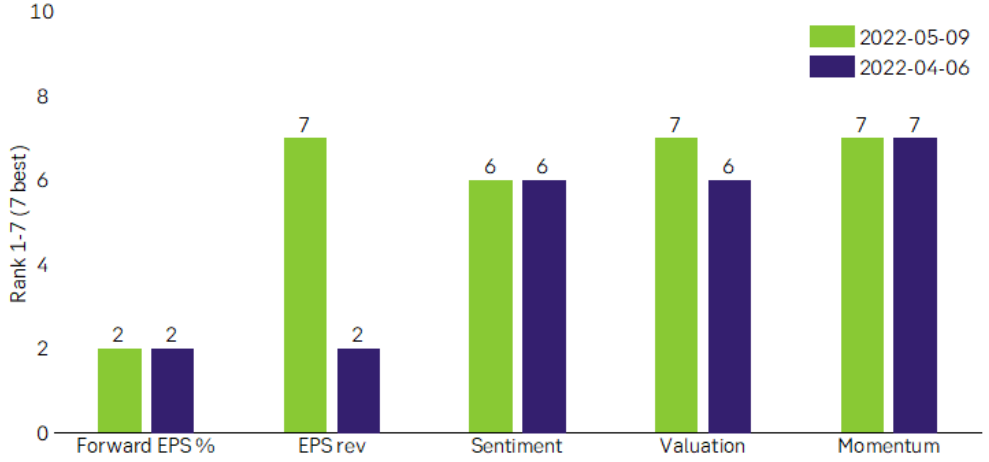
- The Swedish labor market remains strong, with the unemployment rate soon reaching four-year lows as businesses report big labor shortages
- The Riksbank (RB) hiked its policy rate in April, for the first time in seven years, by 25 bps as headline CPI inflation came in higher than expected
  - Economists anticipated the central bank to keep the rate unchanged
  - RB also signaled 2-3 additional hikes this year and balance sheet reduction in June
- Our view is that consumption in Sweden will increase due to higher demand in the post-pandemic cycle and a drop in savings from historically high levels
  - Downside risks are inflation, higher rates and falling consumer sentiment
  - Accommodative fiscal policies and rising employment should give support
- The Nordics overall scores the highest in our Regional Equity model, due to its attractive valuations, positive EPS revisions and strong momentum

Figure 1: Standardized relative valuation – Current constituents



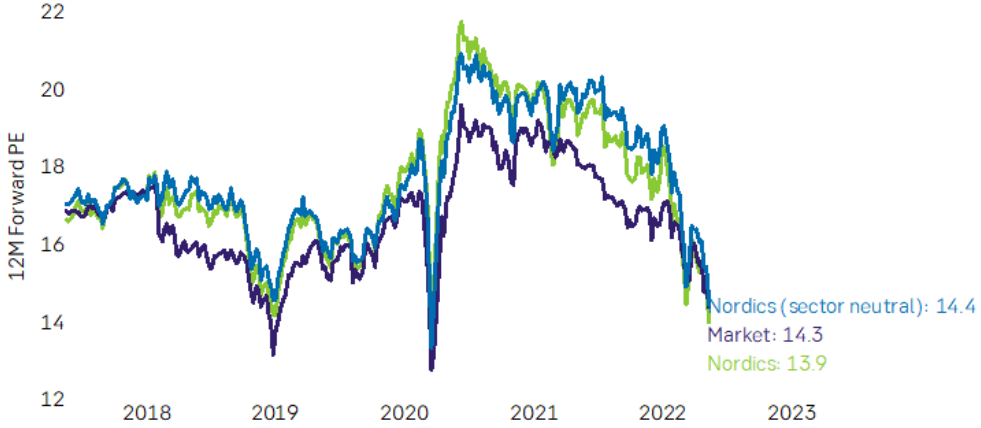
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



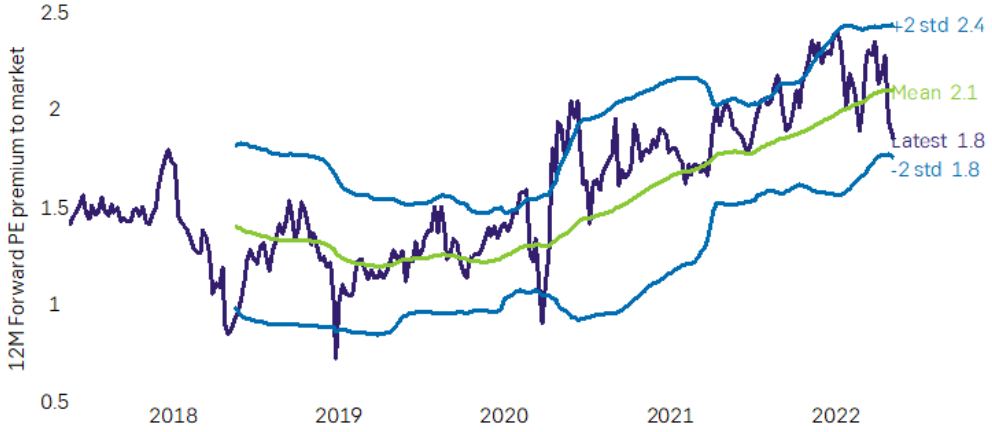
Source: SEB House View

North America – Overweight

US macro and sentiment remain resilient

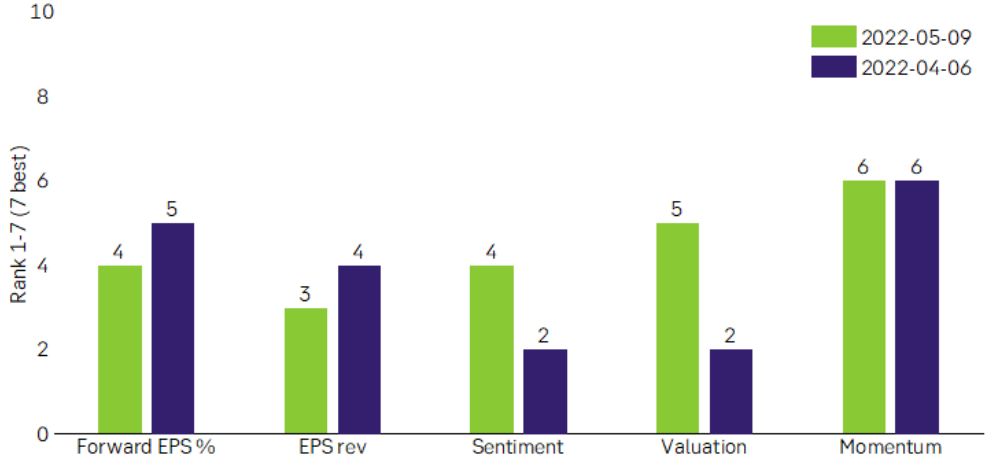
- The Fed will likely be data-driven going forward and adjust normalization if necessary
  - We think that the risk of the Fed causing a recession is low, given its willingness to shift stance when the economy weakened during the last tightening cycle
- US macro data is slowing, but remains strong with a tight labor market and business activity in manufacturing and services still at expansionary levels
- Durable goods orders increased at a faster pace than expected, indicating solid momentum for industrial activity and strong demand for durable goods
- Consumption has also stayed at high levels, with personal spending increasing well above expectations
- The region's PE premium is relatively low as we see that it is currently two standard deviations below its mean
  - We could possibly see expanding PE multiples for US companies from these levels

Figure 1: Standardized relative valuation – Current constituents



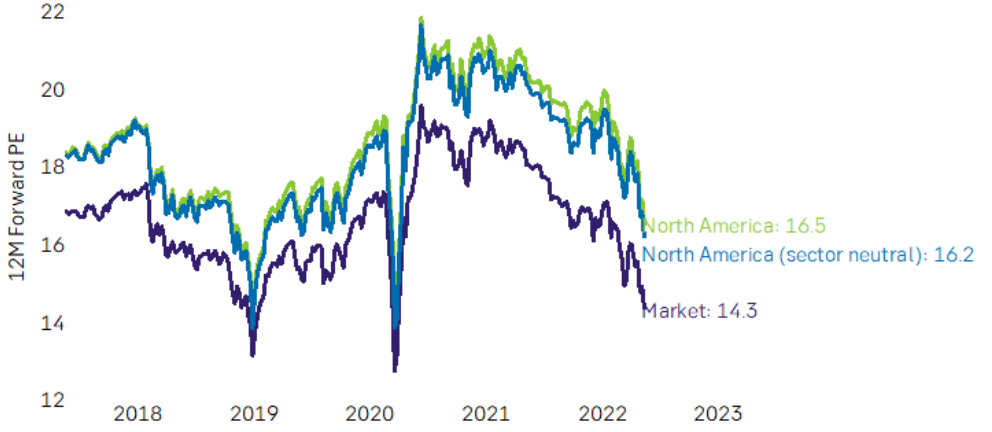
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



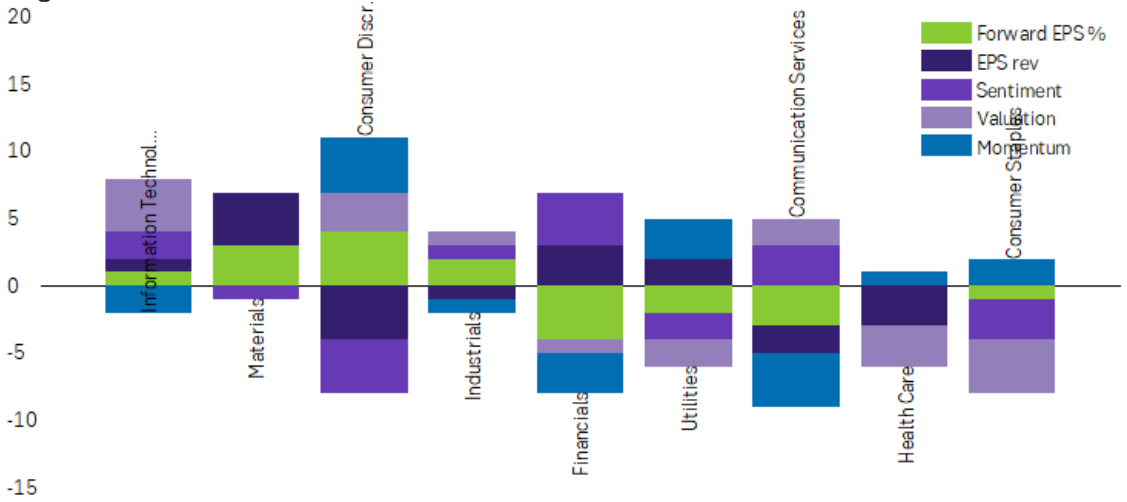
Source: SEB House View

Sector Overview

Sector	UW	N	OW
Communication Services		N	
Consumer Discretionary		N	
Consumer Staples	UW		
Financials		N	
Health Care			OW
Industrials			OW
Information Technology		N	
Materials			OW
Utilities	UW		

* We do not take views on Energy or Real Estate. The former is too much of an oil call and the latter is too small a sector. (X) Indicates last months positioning.

Figure 1: SEB House View sector score



Source: SEB House View

Overweight – Materials, Health Care and Industrials

China's pledge to big infrastructure investments should increase industrial demand

- China will invest more in "hard" infrastructure to strengthen its national security and stimulate the economy, which contracted in April, due to its zero-Covid policy
  - Higher government spending on infrastructure will likely increase demand for industrial goods and services

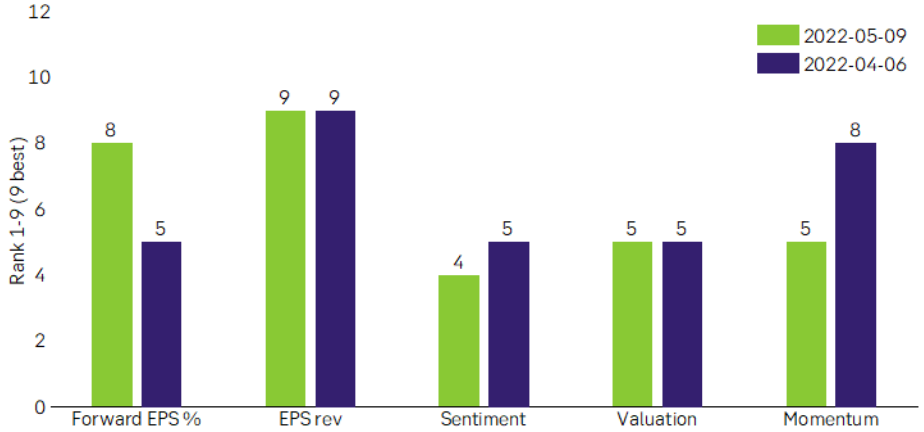
Chinese demand for construction materials should increase as well

- China's push for infrastructure construction should also benefit construction materials and metals & mining within the sector
- Strong EPS revisions and growth contributes to that it scores high in our model

Health Care can work as a hedge against lockdowns in China, but may benefit from a change in covid policy or reopening as more effective vaccines will be needed

- The defensive health care sector will likely see more inflows as uncertainty around inflation, lockdowns in China and the war in Ukraine remains high
- Pharma could also see higher demand for mRNA vaccines if the country reopens

Figure 1: EPS revisions and earnings growth for Materials look attractive

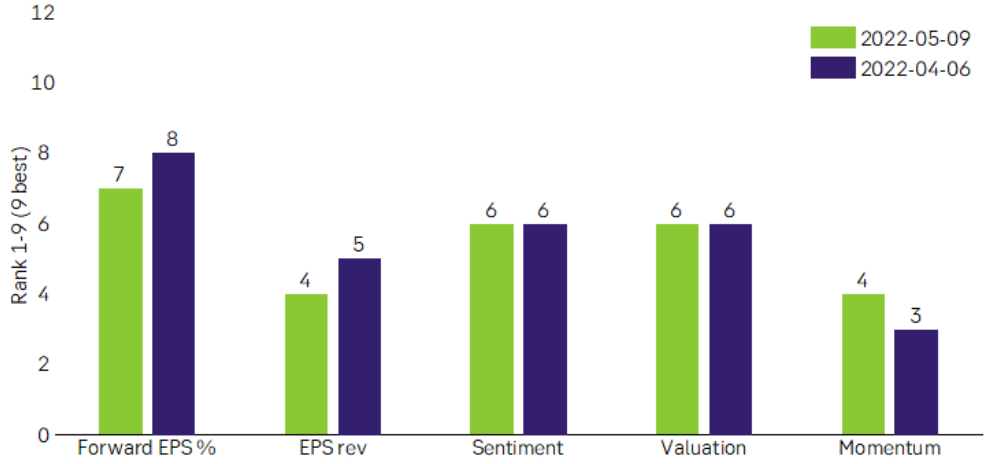


Source: SEB House View

Figure 2: Materials trades at a huge discount vs. the market

Source: SEB House View

Figure 3: Industrials maintains a relatively strong forward EPS growth



Source: SEB House View

Underweight – Consumer Staples and Utilities

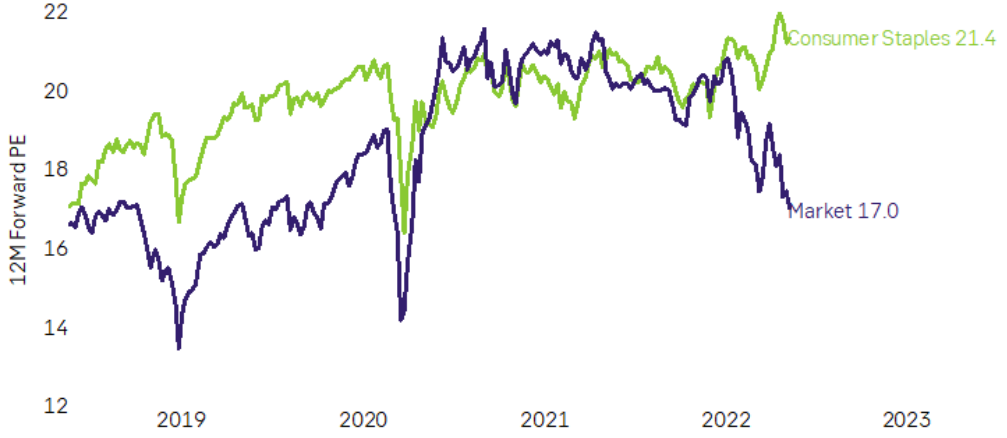
Consumer Staples looks expensive and could face headwinds from higher rates

- The Fed has hiked the federal funds rate twice this year, while the ECB is expected to raise rates at its July meeting
  - The sector, which has a long duration, has historically suffered from higher rates
- Consumer staples is too expensive and achieves the lowest overall score in our model
- Companies within the sector have been able to pass on higher input costs to consumers, but could eventually see margin pressures if prices continue to rise

Utilities has defied higher rates and outperformed, but could come down soon

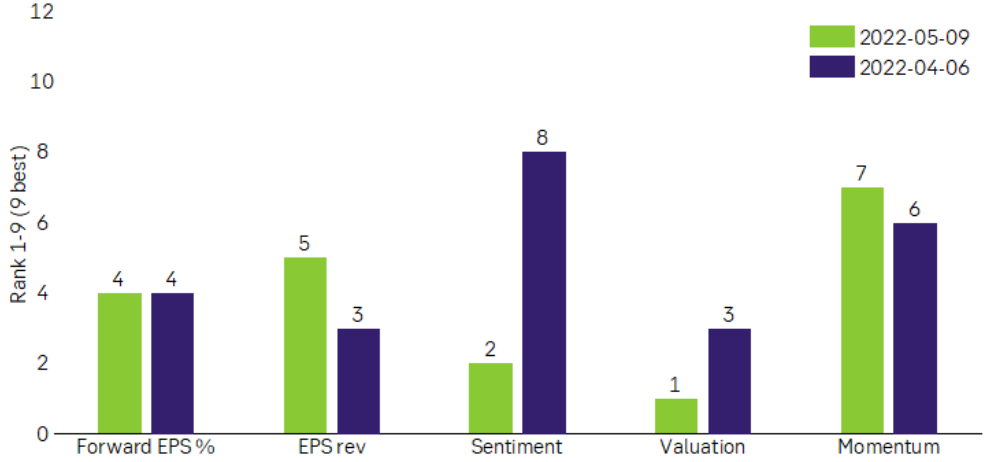
- Rates are likely to keep climbing as global inflation has stayed elevated
  - Higher rates should lead to underperformance in the bond proxy sector
- Utilities trades at a substantial PE premium relative to the market and therefore achieves the lowest rank within this metric according to our model
  - Mean-reversion is likely to follow in the near-term if history repeats itself

Figure 1: Consumer Staples continues to trade at higher levels than the overall market



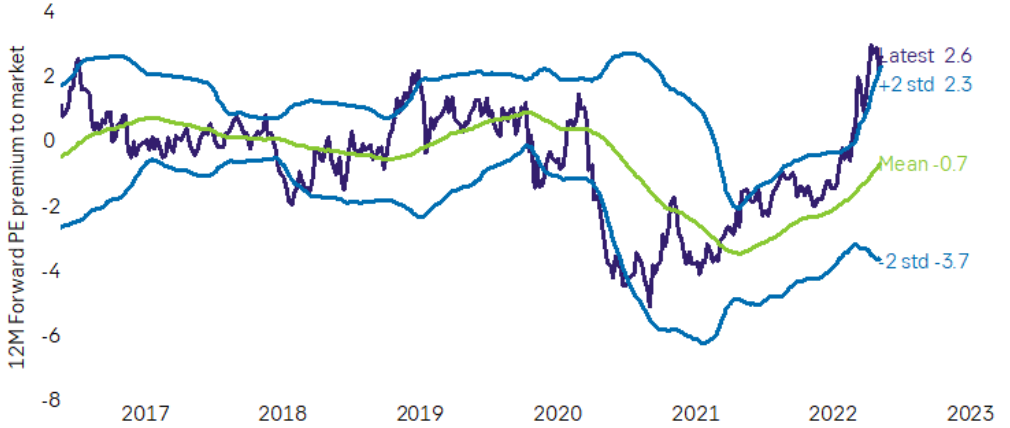
Source: SEB House View

Figure 2: Consumer Staples is the most expensive sector despite a soft EPS outlook



Source: SEB House View

Figure 3: Relative valuations for utilities have re-rated, likely due to its defensiveness



Source: SEB House View

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