Investment Outlook

Finding ways out of a barren landscape

September 2022

SEB

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Introduction

The first several weeks of summer offered a much-needed stock market rebound, after the powerful risk aversion that had prevailed during the first half of 2022. But now that the holiday period is over, market turmoil is back – driven by a combination of factors. Inflation remains high and central banks have clearly stated that they must prioritise tackling it, even though this will come at a cost in terms of economic growth and the risk of job losses. The Ukraine war continues to grind on, and an energy crisis is contributing to persistently very high natural gas and electricity prices, while oil prices appear to have peaked. The energy crisis is primarily plaguing Europe and is not as acute elsewhere in the world, such as in the United States. In addition, China's growth has slowed due to weak international economic conditions, a fragile domestic real estate market and the country's continued restrictive COVID-19 policy. The overall result is that the global corporate sector is signalling tougher times, with uncertainty largely connected to future demand, that is, sales volumes. From a consumer perspective, cash flow has deteriorated rapidly as inflation has eroded purchasing power, with skyrocketing energy prices and rising interest rates as well. Put simply, there are numerous major sources of concern on the horizon. The world's macroeconomists have continued to downgrade their growth forecasts, with most of them agreeing that a recession is approaching. However, there is still considerable disagreement among analysts about how deep and prolonged it will be.

From a capital market perspective, it is thus reasonable to ask whether the above concerns have been sufficiently discounted by investors. One global stock market index in local currencies has fallen by around 17 per cent this year. Price-earnings (P/E) ratios have ended up at around 15, while US 10-year Treasury yields have climbed above 3 per cent and credit spreads for high yield corporate bonds have widened to around 5 per cent. Meanwhile one US dollar costs nearly 11 Swedish kronor. In a shallow and short-lived recession, earnings contraction in the corporate sector is often limited. Today's pricing of equities and corporate bonds has largely discounted this, which is also in line with our main scenario. But if the downturn results in a deeper and more structural crisis, it is reasonable to assume that risk aversion will increase again and that the negative stock market trend will persist. This issue of *Investment Outlook* provides a detailed look at our views about future market developments, risks and opportunities as well as appropriate portfolio structures.

In addition to our overall view of investment portfolios, of course we report on conditions surrounding individual asset classes and on their potential. This issue also includes three theme articles. The first is a review of our take on biotechnology, a cyclically insensitive sector with a growth profile. Our second theme article looks at how investors can identify which companies are actively engaged in the transition to a more sustainable world. Our third theme article looks at current conditions in China. The country is lagging behind its official targets. How do things look as we approach 2023?

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

Market view, risk exposure and allocation

During 2022 capital markets have been under pressure from very high inflation, prompting central banks to respond with very large, rapid key interest rate hikes and extensive planned reductions in their balance sheets. In addition, we have an ongoing energy crisis and a Chinese economy that is in serious distress. Unsurprisingly, all of this has led to radical downgrades in growth forecasts. A recession is now the consensus.

One clear mechanism behind the coming economic slowdown is increased household costs, which in turn are expected to lead to a decline in demand. This is having a major impact on capital markets, with sharply rising interest rates and yields as well as falling stock markets. The question is whether these adjustments in the pricing of financial assets are sufficient, or whether the unfavourable trend will continue. Our main scenario is that the recession will actually be fairly shallow and not too prolonged. Our economic outlook and current valuations, combined with low risk-taking among investors, are the main arguments behind the neutral risk level in our portfolios.

Risk exposure and allocation

This year has turned out to be full of major problems, with a significant unfavourable impact on capital markets. We have been through many difficult periods since the turn of the millennium, and looking back we find both similarities and differences among them. The two major structural crises – the global financial crisis and the pandemic – both resulted in very large, rapid stock market declines and a sudden halt in the economic system.

Low valuations materialised, and a "buy" signal was initiated by massive responses in the form of aggressive monetary policy initiatives by central banks and fiscal stimulus by governments. This does not resemble today's situation, where the economy has gradually slowed as central banks hike key interest rates, and there were some fairly high asset valuations at the outset. This trend is more a combination of classic cyclical downturns combined with deflating valuation bubbles (2000) and central bank tightening (2018). In this type of situation, it is important to have an opinion about the balance between cyclical weakness and capital market valuations and to keep an eye on risk appetite among the investor community. So let us start with our view of the economic cycle.

Downward revisions in GDP growth forecasts, %

Market	2022	Rev.	2023	Rev.	2024
World	3.1	+0.1	2.6	-0.8	4.0
United States	1.5	-1.1	0.5	-1.2	2.0
China	3.5	-1.5	5.3	+0.1	5.0
Sweden	2.6	+0.8	0.0	-1.8	1.7
OECD	2.4	-0.2	0.9	-1.4	2.2
Euro area	2.7	+0.6	0.3	-2.5	2.1
Emerging markets	3.6	+0.4	3.9	-0.5	5.4

The table shows forecasts of real year-on-year economic growth in per cent, in line with our main scenario – expressed in purchasing power parities (PPP), and our revision compared to the forecast we published in May. For a more detailed account of SEB's economic forecasts, see the "International overview" section of this issue, which is an excerpt from the issue of *Nordic Outlook* published on August 30.

Hopes of a soft landing are still alive

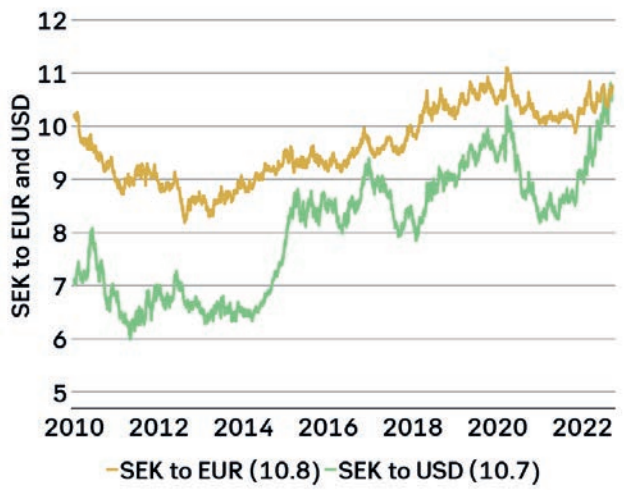
The overall economic picture deteriorated over the summer, forcing central banks to raise key interest rates drastically. Together with a severe energy crisis in Europe, this is eroding household purchasing power, which is the main reason why we have adjusted our growth forecasts sharply downward. Because of some bright spots – easing of global value chains, strong household and corporate balance sheets, and declines in some commodity prices – we expect the recession to be mild. During 2023 as a whole, we expect economic growth to be slightly above zero in the US and Europe. But over the course of the year, growth will slowly rebound. We also foresee a slowdown in inflation this autumn and winter, which means that central banks will not need to hike key rates further next year. Within a few months, we may thus see a situation where macroeconomic momentum turns from negative to positive, but from low levels. However, this picture remains uncertain due to the energy crisis, continued COVID-19 shutdowns in China and the impact on household sentiment of rising inflation and falling asset prices.

A powerful impact on capital markets

The unusual combination of a slowing economy and central banks that have hiked key rates and will continue doing so has had a major impact on capital markets. At this writing, one global equity index in local currencies has lost 17 per cent so far during 2022, the Swedish stock market has fallen by 25 per cent and its small cap index is showing a decline of almost 35 per cent. Ten-year US Treasury yields have climbed above 3 per cent and their Swedish and German equivalent government bonds are at 1.5-2 per cent. Credit spreads in the US and Europe add 5-6 percentage points to underlying government bond yields to give us the current yields on corporate bonds in the high yield (HY) segment. Rising interest rates and widening credit spreads have resulted in negative returns in the range of 14 per cent so far this year on this type of fixed income investment. The US dollar continues to show strength, as it always does in troubled times; today's exchange rate is nearly SEK 11 per USD.

In a balanced portfolio, the positions that have softened the negative outcome so far in 2022 have been holding more global than Swedish equities, preferring defensive companies (e.g. pharmaceuticals) and firms with low valuations as well as in the energy sector instead of growth and cyclical companies, prioritising fixed income investments with low risk profiles and short durations in order to minimise the impact of rising interest rates and widening credit spreads, and lastly seeking exposure to the US dollar. These are all examples of classic behaviour in a period of widespread risk aversion.

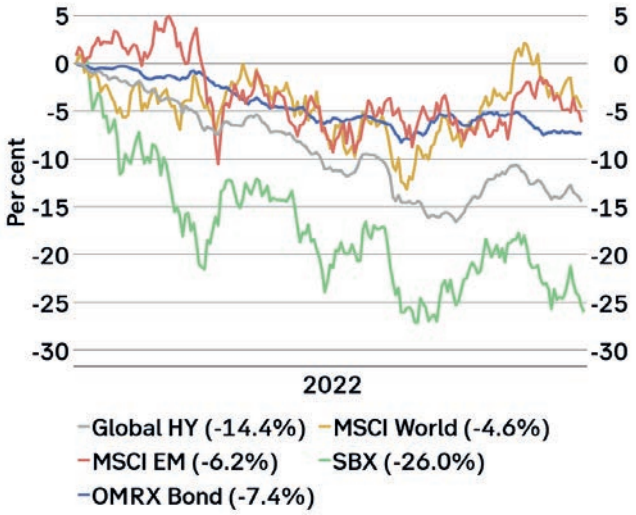
Due to the strong dollar, global equities measured in SEK have held up well



Source: Bloomberg

The chart shows middle rates since 2010 for the Swedish krona against the euro and the US dollar. Because of the weak Swedish krona during 2022, the performance of global equities measured in SEK is considerably less negative than the corresponding figures for the Swedish stock market

Sharp downturns in stock and fixed income markets, as well as a very weak SEK



Source: Bloomberg

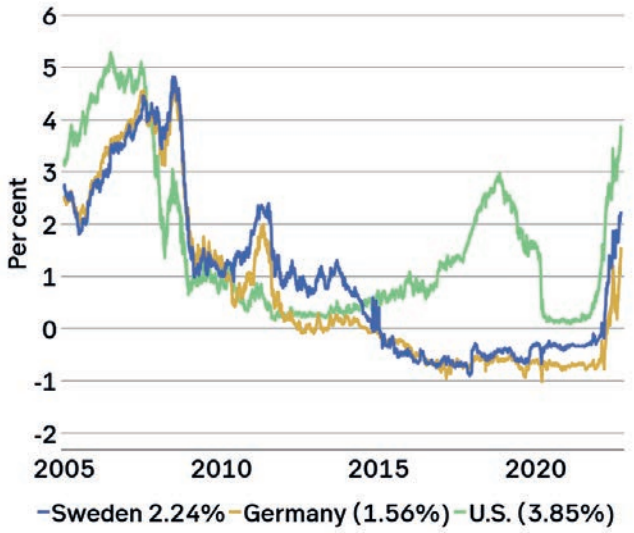
The chart shows the performance since January 2022 of Swedish equities (SBX), the MSCI World Index and the MSCI Emerging Markets Index in terms of Swedish kronor. It also shows the performance of Sweden's OMRX bond index and a global high yield (HY) bond index, currency-hedged to Swedish kronor.

Sharp declines in stock markets, rising interest rates and yields as well as high risk aversion immediately raise the question of whether the recession is already fully priced in, and whether this summer's stabilisation was the first sign that the forward-looking capital market is already breathing a sigh of relief, despite all the problems that are piling up.

Prevailing valuations take worsening conditions into account and are reaching earlier levels

The downward adjustment in financial asset valuations is reasonable, since we are leaving behind us the zero interest rate period and the liquidity support provided by quantitative easing (QE). During this period most assets, financial and real, climbed to high levels. Over the past year, there has been an adjustment towards a financial system once again based on more normal key interest rates among the world's central banks. This adjustment has largely already occurred, since government bond yields have soared to levels familiar from the period before the financial crisis that erupted in 2008. The impact of quantitative tightening (QT) is difficult to calculate, but it should lead to higher interest rates as the supply of bonds rises. In addition, volatility will increase compared to the period when central banks were steady bond buyers (QE). Finally, the yield spread between high and low risk bonds should widen. Implicit in today's government bond yields is an expectation among investors that central banks will succeed in their fight against inflation and that the recession will be transitory in nature.

2-year government bond yields have surged to historically familiar levels

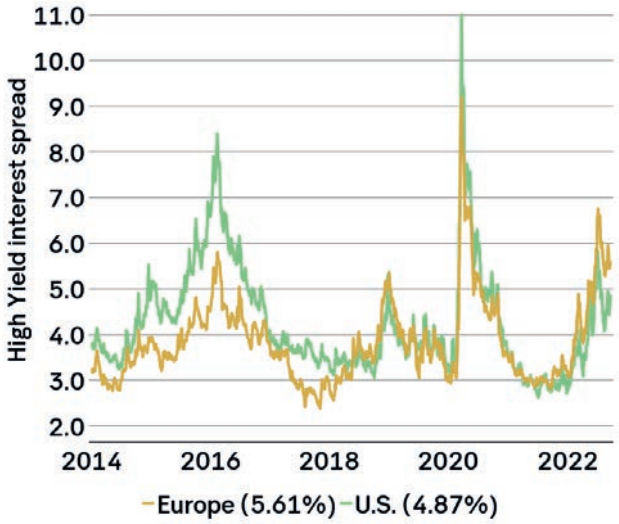


Source: Bloomberg

The chart shows 2-year government bond yields in the United States, Germany and Sweden. Because of their rapid upturn, these are now back at levels prevailing around 2006, before the global financial crisis and before the period of extremely aggressive monetary policy among the world's central banks.

Aside from the above normalisation of underlying government bond yields, we should add widened credit spreads. These indicate heightened market concerns about credit losses and defaults due to shaky economic conditions. If we study the current spread level, we see that it is lower than during structural crises like the pandemic and the global financial crisis, but higher or similar to other less problematic periods such as 2015/16 and 2018. In 2015/16, concerns were related to very low energy prices – which markets feared might result in bond defaults by energy companies – and a generally weak economy. During 2018, concerns were related the US Federal Reserve which – just like today – was hiking its key interest rate and starting to slim down its balance sheet. Today's credit spreads thus indicate that investors anticipate significant problems but that these will not morph into a structural crisis with a major long-term negative impact on the financial system.

Aside from higher government bond yields, spreads to HY yields have widened



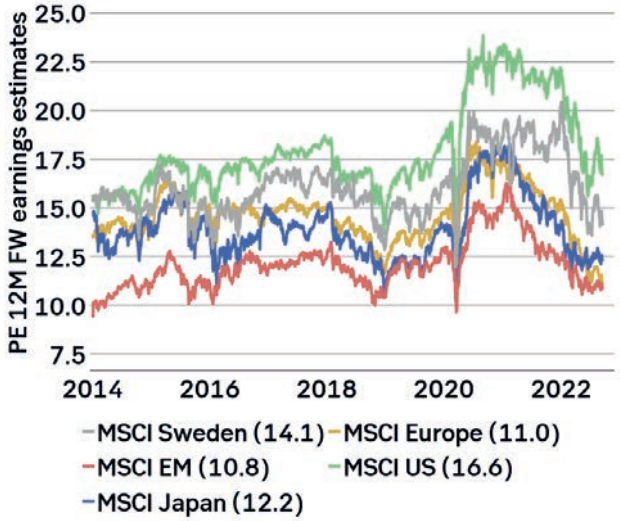
Source: Bloomberg

The chart shows current and historical spreads in the US and Europe between government bonds and corporate bonds in the high yield segment. In periods of market turmoil, when the risk of credit events increases, these spreads widen.

The stock market is closely connected to the fixed income market, so it is hardly surprising that we find a similar adjustments there as well. Prices in the entire stock market have fallen, and the most dramatic change has occurred among growth companies with low or no profitability today. The smallest change has been among companies that already had low market valuations (so-called value companies). The entire valuation spectrum has moved lower and has become more compressed. The same is true on a regional basis. For example the US stock market, the highest-valued over time, has been compressed more than already low-valued stock markets such as in Europe or the EM sphere, where pricing is more in line with their long-term averages. Within each respective market, valuation differences between sectors and individual companies remain very large. This ensures that active stock selection will continue to be very important for expected returns.

The chart below and the chart on the right are linked. The one on the right shows corporate analysts' forecasts of corporate earnings in the global equity market. Forecasts for 2022 and 2023 are currently subject to considerable uncertainty. Survey responses also indicate that investors expect a rougher ride than analysts do. The chart below shows P/E ratios for a number of stock markets, based on forecasts of earnings performance for the next 12 months. The stock market decline, driven by investors, has pushed down valuations much further than the adjustment to earnings made by analysts so far. What supports the analysts' view is that so far, companies have managed to weather the downturn and inflation better than expected, but the question is whether this will also remain true in the future. Investors are discounting a weaker performance. A more detailed view of the future earnings trends can be found in our "Global equities" and "Nordic equities" sections, but there are definitely risks here, strongly connected to whether we have a minor recession or a more demanding, prolonged recession with even lower earnings forecasts by both analysts and investors.

P/E ratios have normalised during 2022...



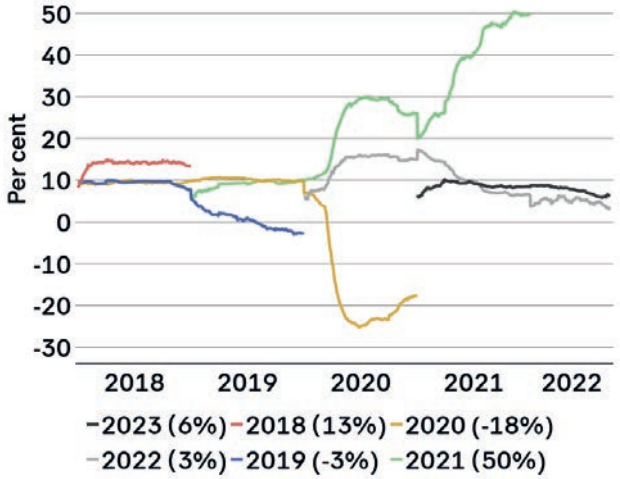
Source: Bloomberg

The chart shows current and historical price-earnings (P/E) ratios for selected countries, regions etc. Valuations are based on MSCI indices. Within each market, there are still very large differences at company and sectoral levels.

Risks are very wide-ranging

In addition to the obvious risks that are associated with our forecast of an ongoing slowdown in the economy and its impact on the profit-generating capacity of companies and the upcoming cycle of credit events and defaults, there are a number of other risks that will be important to monitor in the near term.

... while earnings forecasts do not appear to have discounted coming economic difficulties



Source: Bloomberg

The chart shows analysts' aggregate yearly corporate earnings growth estimates for the MSCI All Country World Index, adjusted over time. Estimates for 2022 and 2023 are below the long-term average range of 5-10 per cent. But in surveys, investors respond that they are far more pessimistic than this about earnings performance over the coming 12 months.

The war in Ukraine is still ongoing, and Russia's aggression there continues, albeit at lower intensity. Meanwhile the Kremlin is retaliating against international sanctions with another weapon: the flow of Russian natural gas to the rest of Europe. This has resulted in an energy crisis that could last a long time and cause a lot of damage. Furthermore, it cannot be ruled out that a cornered Vladimir Putin will resort to even more drastic methods to "win" the war.

So far, inflation has exceeded forecasts. This may of course continue, although the probability decreases with each percentage point by which it rises. A more likely risk is that it will take longer to bring down inflation towards long-term central bank targets. Today, this is expected to happen around the end of 2024. Nor can it be ruled out that higher inflation will prevail even after 2024, for example via an accelerating wage-price spiral.

What will happen to the economic system when we move from extremely low interest rates to more normal ones and shift from quantitative easing (QE) to quantitative tightening (QT)? We are already feeling a lot of the effects via higher bond yields and increased volatility. Perhaps there are also more far-reaching effects that will expose weaknesses in the system, such as the possibility that the debt built up during the stimulus period will be of lower quality that we had estimated. This would lead to further increases in yield spreads and a wider range of yields based on an "actual" quality map of the world's borrowers.

These are just a few of the potential risks and disappointments lurking in the background that might challenge our main scenario.

Risk appetite/positioning among investors more cautious than analysts' earnings forecasts

Unsurprisingly, investors have both reduced their risk exposure and been hurt by negative market movements during 2022. This has reinforced the movement towards more defensive holdings in their portfolios. At present, the professional investor community is cautiously positioned, with a low proportion of equities and a high proportion of cash relative to long-term averages. There have been periods in history with even lower risk-taking, but they coincided with structural crises – such as the global financial crisis of 2008-2009, when plunging stock market prices pushed professional investors' equity allocation to a low point. Individual investors, especially in the US, have not lowered their risk as much compared to their historical behaviour, so an outflow might be generated there. But overall risk-taking is much lower than it has been for a long time, and survey responses on this topic helped to trigger the positive market rebound this past summer. But the rebound has reversed, an indication that we are back at the low risk-taking level seen in mid-June when the stabilisation began.

Today's change in market rates has undermined the TINA (There Is No Alternative) argument that was prevalent during the zero interest rate regime. This should also lead to a reallocation of holdings, and some of them should reasonably flow into the government bond market – which is once again showing positive running yields – but that shift may only come when investors feel more confident that the period of rising key rates is behind us.

Problems are piling up around the world, but the forward-looking function of capital markets justifies our neutral stance

This past summer's respite from the negative market trend is dismissed by many observers as a parenthesis. They maintain that the problems we face are so big that they will take a long time to solve, and adjustments in capital markets will thus have to be more far-reaching than they have been so far. This scenario of a deep, prolonged recession would also see profits fall and credit events and defaults rise sharply from current levels. This is not in our pricing picture (our valuations of financial assets). If this were our main thesis, a continued defensive bias in the portfolio would make the most sense.

Our main scenario is less problematic than the one described above. We expect genuine weakness in 2023 as a whole, but we believe that 2024 will show a clear improvement in economic growth. This implies that economic activity measured month-on-month may bottom out during the first quarter of next year. We also expect inflation to peak at around the same time, with central banks responding by calling off continued key interest rate hikes and instead keeping key rates intact for a period, thereby dampening inflation. Even in this scenario, it is reasonable to assume that corporate earnings will take a hit via lower volumes and, within reason, lower margins. But we are not talking about a collapse in profitability like what we experienced during the pandemic and the global financial crisis, when the whole economic system seized up.

"We expect genuine weakness in 2023 as a whole but believe that 2024 will show a clear improvement in economic growth."

In our main scenario, investors will probably view 2023 as a lost year and instead look towards 2024, i.e. extend their investment horizon. Thus, in the rather near future, investors will factor in a turnaround and improvement in the situation and adjust their risk level and positioning accordingly. In practice, this would mean there is a good chance that risk appetite will bottom out during the second half of 2022. Taking this into account and considering a reasonable valuation and defensive positioning, we end up with a neutral risk appetite in our portfolios – despite all of the current sources of concern.

As a general rule, having a broad risk exposure is appropriate in times of uncertainty. This provides stability and future room for manoeuvre and should be applied whether one is a supporter of the deeper downturn scenario or of the milder variant. This is a principle we have applied to our portfolios throughout 2022, and we continue to do so. It has produced returns that are more robust than they would otherwise have been.

Examples of dampening effects during the year in our portfolios include exposures to Swedish equities with low valuations, an overweight in global equities and its positive currency effect, holdings in alternative investments with low correlation to equities and corporate bonds that have not fallen in value, as well as a short duration in our fixed income portfolios, which has reduced the impact of the upturn in interest rates. Examples of opposite effects are our exposure to growth companies in global equities and our allocation between asset classes, as well as our sustainability-based exclusions, which in 2022 hurt our relative returns when oil and gas prices rose sharply. This is a long-term stance that we believe is sound and that we expect will boost our returns.

In periods of tailwind, risk diversification is often questioned because it comes at a partial cost in returns, while its merits are usually very clear in periods of headwinds. This means we may consider concentrating our portfolios, but first we need more evidence that our scenario is coming true, because then the trend will stabilise and volatility will decrease.

Global equities

Strong companies but a gloomy outlook

High inflation and falling economic growth, combined with liquidity-tightening by central banks, have been a toxic cocktail for the stock market. The trend during 2022 has been the opposite of recent years in terms of sector and style performance. Previously acclaimed growth companies have served as punching bags, while "dirty" sectors such as oil and gas, arms and tobacco stand out as winners. Companies have defied economic headwinds and delivered surprisingly good earnings performance, pulling down valuations and moderating stock market declines.

At the beginning of the summer, investors were deeply sceptical about the stock market. This was reflected in both surveys and risk sentiment indicators. Investors' negative positioning laid the groundwork for a sharp rebound, which surprised many observers given the continued deterioration in global economic conditions. In times of genuine uncertainty, the discount horizon of the stock market quite naturally tends to shorten. The stock market rally during the summer holiday period was accompanied by an extended horizon. Investors started to look around the corner, and they probably discounted a fairly mild slowdown in growth, as well as peaking and declining inflation and key interest rates. This may, however, set the stage for disappointments in the months ahead.

As this issue of *Investment Outlook* indicates, the slowdown in growth will be accentuated and fairly protracted, though not a crash in the style of the 2008-2009 global financial crisis. Today the financial system is far more robust, and private sector balance sheets are strong. But with stubborn and broader inflation defying forecasts on the upside, a European energy crisis unfolding, growth problems in China and central banks using quantitative tightening (QT) to withdraw liquidity, the current gloomy outlook may weigh down the stock market during the next several months.

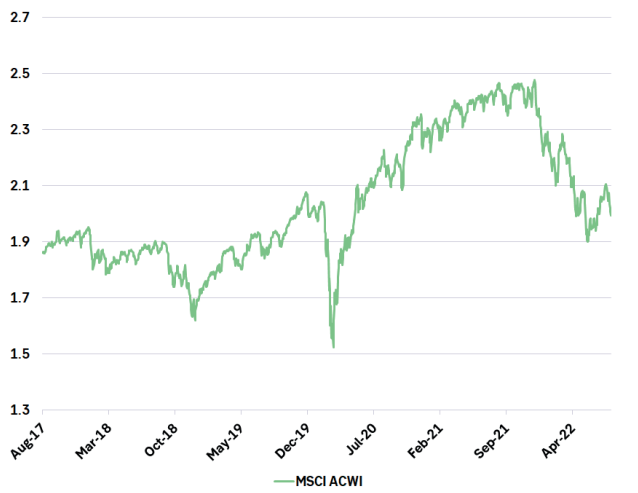
Positive forces are defying headwinds

As always, these concerns are offset by a number of strengths. There is already evidence of cautious positioning among investors. We see signs of easing in global supply chains. Above all, corporate earnings performance has surprised observers on the upside for many quarters, preserving high margins. Perhaps this explains why earnings forecasts for 2022 and 2023 have remained broadly unchanged this year, despite clearly deteriorating economic conditions.

More than 5 per cent earnings increases are in the cards for both years, with exceptionally good earnings performance for various commodity producers helping to keep levels up. But with profit margins at historically high levels while volume growth decelerates, and with clearly problematic inflation for commodities, components, freight costs and wages, there is a major risk of squeezed margins. Heavy demand and an inability to deliver goods have contributed to acceptance of higher prices and hence strong corporate profits, but there is some evidence of a reversal in this trend, as shown by inventory build-up in some sectors. Thus, there is a risk that the demand pendulum will swing back faster than market expectations, which are largely based on the perceived ability of optimistic managers to respond to volume shortfalls and cost increases with efficiency improvements and price hikes. It is worth noting that so far, the positive forces are holding up surprisingly well despite economic and monetary headwinds.

This year's decline indicates that stock markets have discounted much weaker performance than in 2021, which was dominated by recovery. So far during 2022, major stock market regions have performed roughly the same, but with large fluctuations.

Enterprise value (EV) divided by the 2023 sales forecast

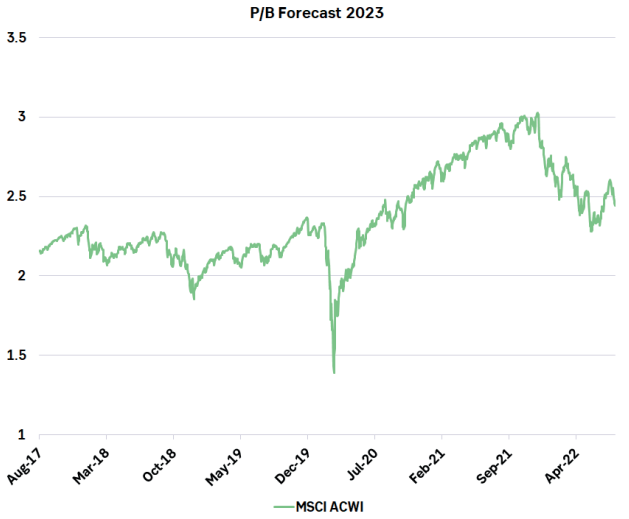


Source: Bloomberg

Enterprise value divided by the sales forecast is at about the same levels as before the COVID-19 pandemic. Corporate multiples still reflect relatively high valuations.

Europe did well early this year despite the looming war in Ukraine and rising energy prices, mainly due to a high proportion of companies with low valuations that performed better during initial key interest rate hikes, but the pendulum has swung to Europe's disadvantage. The US stock market usually fares better than others in times of economic turmoil, as it has this year, despite its large proportion of companies in the underperforming technology sector. Rising interest rates and bond yields plus a strong US currency are usually unfavourable for emerging markets, but as in Europe, low valuations have moderated the downside. We favour the US as a stock market region, since corporate earnings there are relatively resilient in tough times, and we also favour emerging markets since their valuations are low and their monetary policies are less contractive.

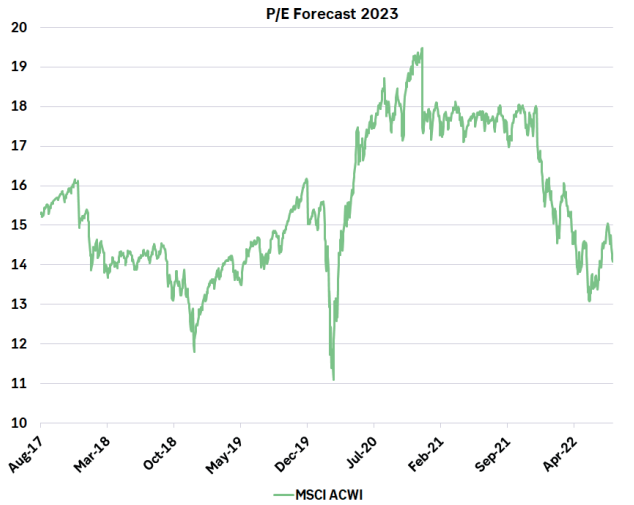
Price-to-book ratios remain historically high



Source: Bloomberg

The chart shows stock price per share divided by book value per share (price-to-book ratio). These valuations are relatively high in a five-year perspective, despite this year's downturn.

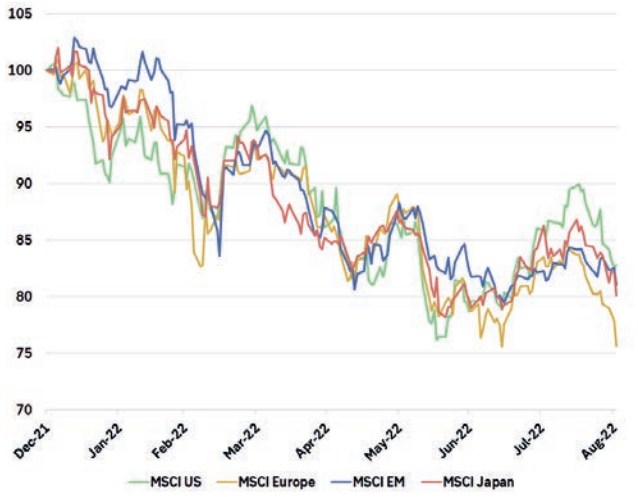
Valuations are back at their historical average



Source: Bloomberg

Valuations (price-earnings or P/E ratios) have reverted to their five-year average.

Relatively small geographic differences in performance



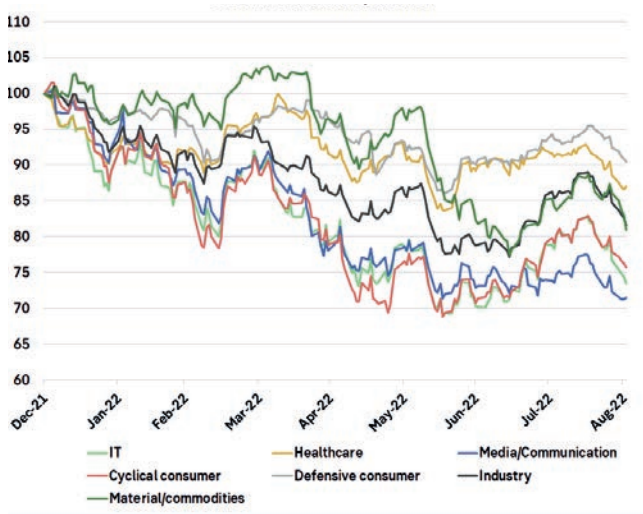
Source: Bloomberg

The chart shows stock market performance this year by region, in US dollar terms. Europe has lagged behind other regions due to worse economic data and rising natural gas prices, while the US stock market has weathered the price decline best despite its high proportion of growth companies.

The sectors with the biggest headwinds in 2022 are previous years' winners

Valuations in technology, media/communications and the consumer sector have fallen significantly, mainly due to previously stretched multiples. Cyclically insensitive sectors such as defensive consumer goods (groceries, tobacco, etc.) and health care have weathered the stock market downturn with minor declines. By far the best performer has been the oil sector – up 22 per cent in USD terms this year – the only sector with positive returns (not shown in the chart below).

Defensive exposures have fared best in 2022 while earlier winning sectors are among losers



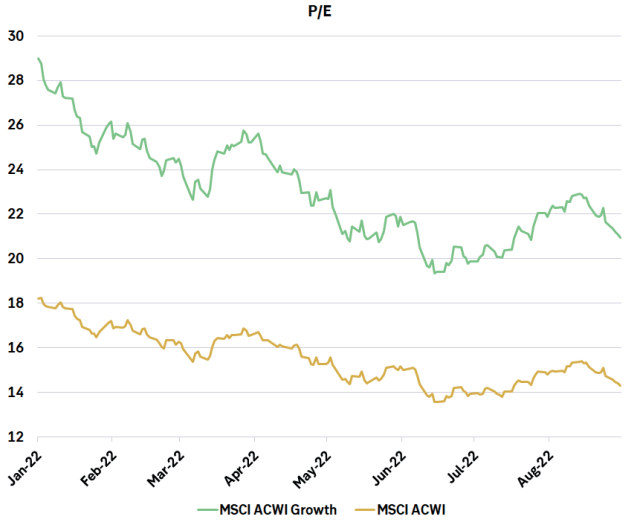
Source: Bloomberg

The chart shows the performance of selected sectors during 2022, in US dollar terms. The oil sector is not included in the chart, but it is worth noting that oil companies surged in stock markets and were up by more than 22 per cent in early September compared to year-end 2021.

In our main scenario, which can best be described as a controlled recession, quality companies with strong cash flows and balance sheets and with the ability to increase sales and earnings without too much help from the economic cycle should fare best. This type of company can be found in most sectors but is most well-represented in the technology and health care sectors.

Share price declines, coupled with decent earnings increases, have clearly brought down earnings-based valuations. As the chart shows, price-earnings ratios for growth companies with higher valuations have fallen the most, which makes sense because their valuation premiums were at record levels and they are more sensitive to interest rate upturns.

Growth company valuations have fallen more than those of other companies



Source: Bloomberg

Price-earnings (P/E) ratios of growth companies have fallen from 29 to 21 so far this year, while broad market P/E ratios using the MSCI All Country World Index have fallen from 18 to 14 during the same period.

Global equities are currently valued at their historical average multiple, measured as a P/E ratio, so there is a risk of further earnings multiple contraction if conditions deteriorate further. Slow-changing figures such as price-to-book ratios are at higher levels, reflecting a relatively high margin assumption. In the event of a deep economic downturn, it will be difficult to defend profitability. Current earnings assumptions will also be severely undermined. It is thus difficult to buy shares on the basis of the valuation parameter alone.

If macroeconomic developments during the autumn give us reason to be optimistic about the depth of the slowdown and the level of inflation and interest rate increases, then the rally of this past summer may well mark the beginning of a new positive trend in stock markets. But given today's clear headwinds and fundamental uncertainty, the risk that markets will again be testing the lows reached in mid-June should not be underestimated. We will need to live with a continued uncertain stagflation environment, which we believe will give way to an economic recovery accompanied by falling inflation during 2023. There are reasonably good prospects of an upward stock market trend from current levels, but probably with major fluctuations.

Nordic equities

Light on the horizon

Despite major but extremely well-publicised problems in the near term, we are now starting to see the light at the end of the tunnel for Nordic equities. Apart from Swedish small and mid-sized companies, virtually all of the bubbles we have warned investors about over the past year or so have now disappeared and the Nordic equities market as a whole looks attractively valued.

The US Federal Reserve's inflation-fighting efforts have stabilised long-term inflation expectations and market yields. The European Union faces an acute large-scale energy crisis, but it is being managed better than might have been feared and is stimulating major energy investments. Nordic companies are relatively well-positioned to manage the energy crisis, and there are many winners. The earnings trend has been surprisingly resilient so far, though enjoying a significant boost from the exchange rate trend and a weak Swedish krona. In terms of the economic cycle, the worst is yet to come, but the stock market always discounts events ahead of time to the best of its ability. It may soon be time to discount the next upturn. The war in Ukraine and China's COVID strategy are two major elements of uncertainty holding back otherwise growing optimism. All in all, we see unusually good prospects for selective purchases among Nordic large caps and expect a positive performance for equity indices as a whole in the year ahead.

Surprisingly solid earnings trend

Second quarter earnings reports were not the catalyst for downward-revised earnings forecasts that we and many investors had feared. They were in fact an important partial explanation for the summer's relatively strong stock market performance. But given all the woes facing the market, in the form of the energy crisis, inflation and rising key interest rates, it was probably just a question of time, when – not if – earnings would start to fall and analysts would be forced to make sharp downward revisions in their forecasts. That was the thinking. After meetings with representatives of many Nordic large cap companies in late August, SEB can note that demand still looks good for many companies. Some segments are seeing the effects of depressed consumers, whereas other segments are benefiting from major investments in the energy field.

Earnings of Nordic listed companies, especially Swedish ones, are being pumped up to some extent by weak currencies. The Norwegian offshore oil and gas sector is booming. Many Nordic industrials are also relative winners from the energy crisis thanks to relatively better access to reliable energy sources at significantly lower costs than competitors in continental Europe.

There are often a variety of reasons for this – not just the region's favourable supply of mostly hydroelectric but also wind and nuclear power. A surprisingly large number of competitors in energy-intensive industries on the continent have not secured their energy supply with long-term contracts, as has virtually every major energy-hungry company in the Nordic region. Many Nordic companies have also made more progress in improving their energy efficiency, often related to their sustainability investments. For example, in the forest product industry, it is striking that Nordic manufacturers replaced fossil energy with biomass long ago, to a far greater extent than their continental competitors. Although they are adversely affected by higher costs, the forest product and metal industries in the Nordic region stand out as relative winners from the energy crisis, at least in a short-term perspective.

Continued stable or positive earnings growth in the Nordic region

Source: Bloomberg, SEB

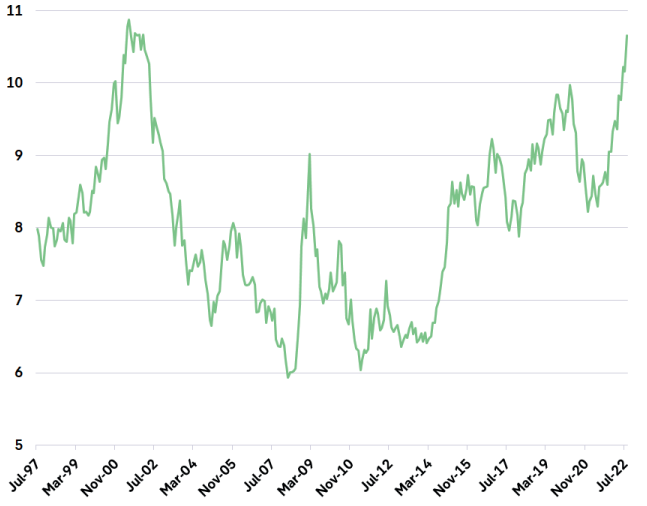
The chart shows the indexed earnings trend and 12-month consensus forecasts for the VINX Nordic index and the 30 most liquid shares on the Stockholm stock exchange. So far no weakness is apparent, despite ominous economic signals, the energy crisis and cost inflation. Recent communications from a number of large listed companies indicate that the third quarter will not be a catalyst for major downward revisions either.

Winners from the investment surge

The energy crisis also has an upside. A relatively large number of Nordic industrials have good potential to benefit from the investments now being made in the energy field. In conjunction with the annual SEB Nordic Large Cap Seminar in late August, various industrial companies noted that "everything in the energy sector" is performing strongly. Investments are being made in renewable energy sources as well as in nuclear and fossil energy. Products to improve energy efficiency such as heat pumps also continue to see strong sales. One subcontractor of equipment that can be used to handle liquefied natural gas (LNG) reports an exceptionally favourable market situation, with its order books filled for the next five years. The rapid pace of investment activity for LNG has another upside, according to the managing director of one of Sweden's biggest industrials.

Companies across Europe have been quick to invest in alternative solutions and ensure that operations can continue to be run more or less as usual even if/when natural gas deliveries from Russia end. The most common solutions are probably ones that accommodate LNG purchases, but major investments are also being made in biogas/biomethane and other energy alternatives. For a number of listed Nordic industrials, an upturn in demand from the energy sector is probably more important than the slowdown seen for more consumer-oriented products. At least some aspects of this energy investment boom could continue for many years.

Weak krona is pumping up earnings of Swedish listed companies



Source: Bloomberg

The chart shows the Swedish krona to US dollar exchange rate. It has been more than 20 years since the krona has been so weak against the dollar. The strong dollar/weak krona helps to boost earnings of Swedish listed companies. The Norwegian krone, euro and Danish krone are also historically weak against the dollar.

Clearly identified losers

Many companies are and, above all, will be adversely affected by reduced household consumption capacity due to high energy bills and rising interest rates. We believe there is widespread speculation about this. For example, historically low valuations for Swedish consumer goods companies should reflect investor fears that analysts have not factored sufficiently negative assumptions into their earnings forecasts. The average price-earnings (P/E) ratio for six of the largest consumer goods companies on the Stockholm stock exchange, excluding the retail food industry, is 27 per cent lower than the average for the past five years and 35 per cent lower than one year ago. Analysts have clearly already noted and tried to factor in the economic problems they foresee for consumer goods companies. Earnings forecasts for all these companies have been revised sharply lower over the past six months, but obviously it remains to be seen whether this is sufficient. A clear contrast to consumer goods companies is found in normally very non-cyclical pharmaceutical companies. Their valuations today are at the same level as one year ago and 13 per cent higher than their 5-year average.

Our conclusion from this is not to buy shares in consumer goods and sell pharmaceuticals, or the opposite, but it does probably mean that consumer goods companies will have to be hit much harder than analysts have estimated so far in order to justify further declines from today's already depressed share prices.

Historically large discount for consumer goods vs pharmaceutical companies

Source: Bloomberg, SEB

The chart shows the 12-month forward consensus price/earnings ratio for six Swedish consumer goods companies (unweighted average, and excluding food retailers) and the two largest pharmaceutical companies on the Nordic stock exchanges. While analysts should already have taken some slowdown into account in their earnings forecasts for consumer goods companies, investors have factored historically large discounts into share prices for these companies. If an investor wants to adopt a negative stance towards consumer goods stocks based on current prices, it is not enough to realise that these companies will be adversely affected when consumers cut back their spending. The effect probably needs to be much greater than analysts have already assumed in their forecasts.

China's policies may have major consequences, but they are hard to gauge

China's extremely aggressive COVID-fighting measures have already had enormous consequences for its economy. Despite a very high youth unemployment rate for the country and what is essentially a collapse in both new residential construction and consumer confidence, there are still no signs that the country intends to revise its COVID strategy, which has devastated the economy. The outcome is difficult to gauge, but it may lead to new negative shocks for the world's economy. Large-scale shutdowns in Shanghai earlier this year had significant repercussions for the global transport system and for the supply of some critical electronic components, among other products. One of the few clear bright spots for the economy and corporate earnings is the improved supply of everything from transport capacity to electronic components. However, this may quickly change for the worse again if the trend in China moves in the wrong direction. For some time now, companies in the West have worked hard to diversify procurement sources when they are highly dependent on Chinese subcontractors. However, this adjustment will take time, and they remain highly dependent on China.

A surprising deterioration or expansion of the war between Russia and Ukraine is another potential threat. Unlike the energy crisis and the economic slowdown, which have already received considerable attention, China and Russia are potential sources of unpleasant surprises that may create stock market turbulence. However, it is rare for an event that the market has had a long time to factor into prices to cause great turbulence once it occurs. Russia recently halted gas deliveries to the EU, and at this writing it is still uncertain what the EU's policy response will be, in terms of energy price regulations and related allocation mechanisms (rationing). Depending on what is done, this may also create significant stock market movements. Yet these developments are not like a bolt from the blue, but have gradually shifted from being a question of "whether" it will happen to "when".

Valuations look attractive again

Exactly one year ago, we warned of bubbles in a number of Nordic stock market sectors – including investment, real estate and special purpose acquisition companies. We also highlighted the alarming valuations for many so-called growth companies. Together, these industries contributed to worryingly high valuations for the entire stock market, and we thought things would get worse before the bubbles burst. Today, however, the situation is completely different. Although valuations for the Swedish small and mid cap segments are still not particularly appealing, Nordic listed companies as a whole are once again attractively valued, with historically low P/E ratios and relatively normal equity valuations.

The major Swedish companies that constitute the OMXS30 index once again have attractive valuations both in terms of earnings and more sluggish multiples such as price-to-book ratios. Multiples are near their 10-year lows. With today's valuations, no earnings trend miracle is needed going forward to enable a long-term investment to be successful. Dividend yields alone are expected to be 4 per cent for the OMXS30 in the year ahead. A low valuation does not guarantee a good return but does provide added protection if, for example, the earnings trend should not live up to expectations.

Just as there were plenty of bubbles and strong suspicions of bubbles in the stock market when equities were at their most expensive at the beginning of 2022, there are plenty of attractive equities today when average share valuations are at a 10-year low. In our view, there are good opportunities today to buy what will turn out to be genuine stock market bargains going forward. However, this strategy is not risk-free; extraordinarily low valuations for individual companies may also be an alarm bell and a sign that something is not right.

Stabilisation of long-term inflation expectations provides support

In late summer, as well as at times earlier this year, the stock market has shown a strong negative reaction to hawkish communication from central banks, led by the US Federal Reserve. However, we think it is clearly encouraging that – despite the recent sharp upturn in short-term yields, which reflect expectations of larger, faster key interest rate hikes – yields on bonds with long maturities, such as 10 years, have not climbed above their June peaks (at least not yet).

Large cap valuations near a 10-year low in Sweden

Source: Bloomberg

The chart shows the price-to-book value ratio for Nordic and Swedish listed companies. The VINX index comprises 187 Nordic large and mid cap companies while the OMXS30 consists of the 30 most liquid shares on the Stockholm stock exchange. The OMXS30 is close to a 10-year low. The VINX is still somewhat high in a historical perspective but is no longer alarmingly expensive, as it was at the beginning of 2022.

Ten-year inflation expectations are back to around 2.5 per cent, a level already reached in May 2021 and which can thus be described as rather stable again after a period of turmoil during the spring and early summer, when they occasionally exceeded 3 per cent. We see this as a sign that the market has regained its confidence in the Fed's ability to manage inflation.

It is hard to justify significantly lower share valuations based on the developments we have seen so far in the fixed income market, including expected future key interest rate hikes. Despite recent stock market turbulence, driven by central bank actions, we believe the threat to the stock market from rising inflation and higher return requirements has eased. But one headwind that we will be forced to live with for a long while is central bank quantitative tightening. Central banks will not provide support for ever-rising asset prices, as they did over the past decade and especially during the years of the COVID pandemic. Instead we will now have the opposite effect.

Summary

The earnings trend among Nordic listed companies has been surprisingly resilient so far, though with significant support from exchange rate effects. In terms of the economic cycle the worst is yet to come, but the stock market always discounts events ahead of time to the best of its ability, and it may soon be time to discount the next upturn. However, the war in Ukraine and China's COVID strategy are two major uncertainty factors holding back otherwise budding optimism. All in all, we see unusually good prospects for selective purchases among Nordic large caps and expect a positive performance for Nordic equity indices over the coming year.

Low earnings valuations for Nordic and Swedish companies

Source: Bloomberg

The chart shows the 12-month forward consensus for the VINX Nordic and OMXS30 indices. The VINX comprises 187 Nordic large and mid caps, while the OMXS30 consists of the 30 most liquid shares on the Stockholm stock exchange. Last year's bubble valuations are just a memory. P/E ratios for Nordic companies and for large caps on the Stockholm stock exchange are now at 9-year lows.

Inflation expectations and long-term yields rates have stabilised

Source: Bloomberg, SEB

The chart shows US 10-year Treasury yields, 10-year inflation-adjusted Treasury yields and 10-year inflation expectations. After an investor run earlier in the year, the market has regained its confidence in the Fed's ability to deal with inflation. Its aggressive rate hikes have helped push down inflation expectations to the same level as in October 2021. Long-term yields have been relatively stable following a surge between March and May 2022. Long-term yields are normally more important to share valuations than short-term yields, which continued to climb as a result of expected aggressive measures by the Fed to fight inflation.

Fixed income investments

Upturn in long-term yields will end soon

The sharp upturns in long-term yields and widening credit spreads that dominated the fixed income market during the second quarter peaked at the start of the third quarter. At that point, US 10-year government bonds were trading at a 3.50 per cent yield, up two percentage points since the beginning of 2022. Meanwhile the credit spread between US high yield corporate bonds and Treasury securities with the same maturities was 6.0 per cent, a doubling since the start of the year. These movements were explained by record-high inflation, which prompted the world's major central banks to take forceful measures using their interest rate weapon – in both words and actions – and by fear of the negative impact that rate hikes would have on economic growth, in the worst case a recession.

Government bonds (excl emerging markets)

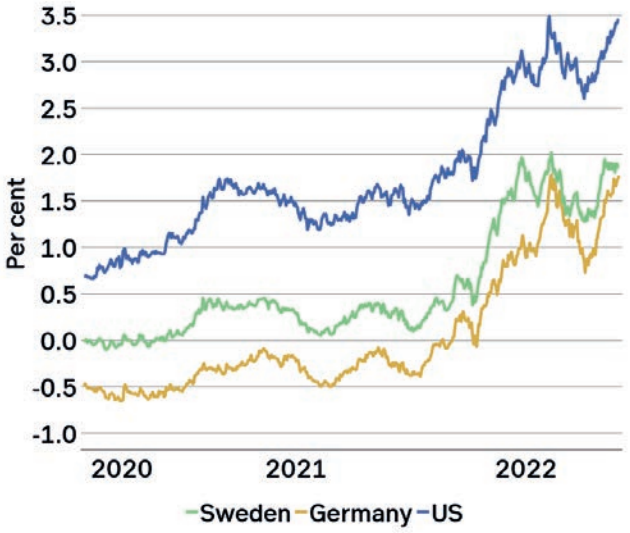
More cautious rhetoric from the US Federal Reserve (Fed) put a stop to rising bond yields in early July, which even led market players to start forecasting cuts in key US interest rates during the first half of 2023. The trend over the past 40 years shows that US long-term bond yields normally peak just before the Fed ends its rate hiking cycle. It also means that US 2-year and 10-year government bond yields will trade at the same level, or just below the federal funds rate at that stage.

According to our updated forecasts following the publication of *Nordic Outlook* and the release of August US inflation data on September 13, we expect 10-year Treasury yields of 3.80 per cent by the end of 2022, based on our forecast that the federal funds rate will have peaked by then at 4.00 per cent. We believe there is only a low probability that 10-year yields will surpass 4.00 percent unless growth prospects improve significantly, which would justify further rate hikes. Next year, we expect US long-term yields to be 50 basis points below the fed funds rate just before the Fed carries out its first rate cut. Taking this and quantitative easing into account, our forecast is that US 10-year yields will be 3.30 per cent at the end of 2023 and 2.60 per cent at the end of 2024.

Although the European Central Bank began its key rate hikes as recently as July 2022, we now also expect the ECB to end its rate hiking cycle by early 2023. The deposit rate will peak at 1.75 per cent and the refi rate at 2.25 per cent, just after the fed funds rate tops out. We expect long-term global yields to move upward again this autumn, but they will not reach the levels seen in June this year. German long-term yields have followed expectations of the ECB's rate hiking cycle. In June, when the market expected the ECB deposit rate to reach 2.50 per cent in 2023, German 10-year yields were at 1.93 per cent. Despite high inflation, it is unlikely that these short-term interest rate expectations will return, now that economic growth is slowing. The end of the ECB's QE programme (to increase liquidity) is expected to help push long-term yields somewhat higher. Our forecast is that German 10-year yields will reach 2.00 per cent in 2023 and then fall in 2024, when the ECB cuts its key rates.

Sweden's Riksbank, which was late out of the starting blocks, has now accelerated its pace and is expected to deliver a rate hike of 75 basis points in September followed by a 75 bp hike in November. After a final smaller increase in February 2023, its key interest rate should peak at 2.50 per cent. Sweden's long-term yield spread against Germany showed high volatility this past summer, with the spread widening for bonds with shorter maturities. Meanwhile the 10-year yield spread has narrowed significantly. As with US Treasuries, the Swedish yield curve has inverted, which means that 2-year government bonds are trading at higher yields than 10-year government bonds. The Riksbank will almost completely end its bond buying in 2023 – and will hike key rates more than the ECB – which indicates that the yield spread will widen somewhat in the year ahead.

High 10-year government bond yields again after a summer downturn



Source: Macrobond

The Federal Reserve's more cautious rhetoric on monetary tightening caused 10-year government bond yields to slump temporarily during the summer.

Government bond yield forecasts

10-year government bond yields	Sep 19	Dec 2022	Dec 2023	Dec 2024
US	3.49	3.80	3.30	2.60
Germany	1.80	2.00	1.90	1.80
Sweden	1.87	2.25	2.40	2.30

Source: SEB, september 2022 forecasts

US 10-year Treasury yields are expected to peak in late 2022, while yields on their Swedish counterparts are expected to fall during 2023.

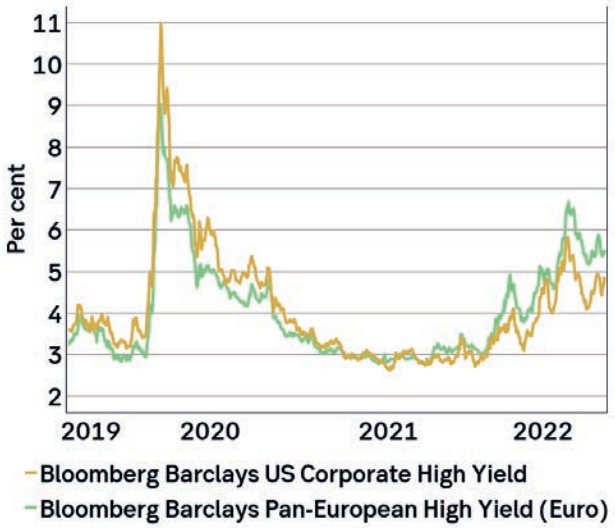
Corporate bonds – investment grade (IG) and high yield (HY)

Market conditions were very tough for corporate bonds during the first half of 2022. The sharp rise in long-term yields had a negative impact on all fixed income investments with some form of maturity. Meanwhile there was a growing risk of corporate credit events as interest rates rose. Other factors were higher costs and fears of weaker demand in a world of slower economic growth. The direction of long-term yields and credit spreads was not the only inhibiting factor. The size of movements has been unusually large. US 10-year Treasury yields rose from 1.50 per cent at the start of the year to 3.50 per cent just before the end of June. At this writing they are around 3.25 per cent. It was the same picture for credit spreads on US high yield corporate bonds. They started the year at 3 per cent before rising to 6 per cent at the end of June and are now trading around 5 per cent. In late July, the Federal Reserve chose to ease up somewhat on its earlier tightening rhetoric. This led to a slight relief rally during the summer.

Looking ahead, there are both positive and negative factors to take into account for corporate bonds. The negative impact of rising interest rates should lessen as inflation stabilises and then falls, while much of central bank communications on rate hikes has been priced into the market. Higher interest rates obviously mean higher funding costs for companies, but many chose to reschedule some of their loans when interest rates were low, thereby softening the cost impact of higher rates. The flow situation, which was consistently negative for much of the year, has stabilised. As a result, market positioning has adjusted to some extent to more difficult conditions.

The factor now contributing the most to uncertainty is corporate credit risk. Although quarterly earnings reports for both the first and second quarter of 2022 lived up to expectations, and the number of credit events is currently at a record low, a potential recession could change the picture for the worse relatively quickly. The credit ratings agency Moody's believes that the rate of credit events in the high yield segment will rise from just below 3 per cent today towards the historical average of around 4 per cent by 12 months from now. If the slowdown in economic growth were to bring downside surprises, that would imply a higher percentage of credit events and thus wider credit spreads in the corporate bond market.

Recession fears raise the credit risk for corporate bonds



Source: Bloomberg/Macrobond

Assuming sharp central bank rate hikes, the slowdown in economic growth may lead to recession. This has increased credit risk and widened the yield spread for corporate bonds in the high yield segment.

Emerging market debt (EMD)

Rising interest rates, a strong US dollar and growing fears of a future recession have led to difficult conditions for emerging market bonds in 2022. This has led to both sharply lower prices and outflows for this kind of fixed income investment, in line with the risk aversion that has characterised other markets during the year. Overall, it can also be said that countries with commodity production have fared somewhat better, while interest in Asian investments has been noticeably cool.

Despite the headwinds that have blown during the year, there is reason to be more optimistic about the future. Many emerging markets, such as Brazil, Mexico and South Africa, have implemented sharp hikes in their key interest rates, which currently range between 5 and 13 per cent and thus offer significantly higher yields than advanced economies. The fact is that the majority of emerging markets have interest rates that exceed their 10-year average. Obviously, the reason for these high interest rates is persistent inflation, but falling commodity prices together with lower demand indicate that inflation may slow. Meanwhile investor interest increased early in the third quarter, when outflows turned into inflows.

If recession were to become a reality, it would hurt high-risk credits such as high yield bonds. At the same time, a strengthening of the US dollar can be expected in such a scenario given its status as a safe currency, which would probably have an especially negative impact on emerging market debt investments. Investment grade bond holdings would thus be preferable to EMD, given persistent uncertainty about global economic growth

Theme: Breakthrough for biotechnology

Small biotechnology companies have taken a heavy beating in global stock markets over the past 18 months. Their shares have become so cheap that the big pharmaceutical companies can buy up nearly the entire sub-sector with the money in their coffers. There are a number of reasons for this perfect storm, which we will explore in more detail to see whether we may be nearing a low point. The sector is still well supported by megatrends and is also driven by exponential growth in technology and innovation. The playing field has changed, but there are many indications that the best days lie ahead for companies with good research and new products.

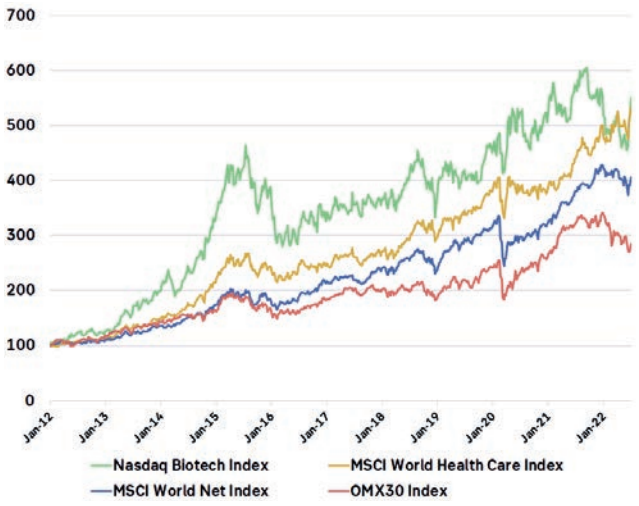
In Sweden, biotech companies usually symbolise enterprises with no revenue or profits, so-called high-hope companies. But in the US the industry is more mature. Plenty of biotech companies are profitable, and some of them are as large as the biggest pharma companies. Smaller companies are often acquisition candidates when they near commercialisation, and such acquisitions are part of the big companies' business model. Along with doing a large share of their own research, the big companies usually allocate 30-50 per cent of cash flow to dividends and share buybacks and the rest to acquisitions. The original definition of a biotech company is that it researches and develops protein-based pharmaceuticals – large molecules that must be grown and injected – whereas a pharma company makes small-molecule chemical compounds in the form of pills. However, nowadays pharma companies do both, and the dividing line between the two sectors has blurred.

Global stock markets had a tough first half of 2022. High inflation, driven by high energy prices and COVID-disrupted supply chains, has forced the world's central banks to take action. They have tightened liquidity and hiked key interest rates, which has clearly lowered growth expectations. The market has now begun to worry more about a coming recession than about an overheated economy. In this volatile market, big health care companies are coping relatively well. Large pharma companies have very little exposure to energy, supply disruptions, war and recession. People need medicine and health care even in hard times.

A bubble resembling the dot-com crash

However, the interest rate-sensitive biotechnology sector – especially smaller companies – is still characterised by sharp share price fluctuations, but we believe the bottom is near after an 18-month downturn. Two indices representing small and mid caps in the biotech sector – the Russell 2000 Biotechnology and SPDR S&P Biotech (XBI) – reached their peak in February 2021 and were down at most 70 per cent by June 2022.

Strong stock market performance



Source: Bloomberg

For the past 10 years, both the NASDAQ Biotech Index and the broader MSCI World Health Care Index have outperformed a benchmark global equity index and the Stockholm stock exchange (recalculated in SEK).

The February 2021 peak and subsequent downturn resemble the dot-com bubble at the turn of the millennium, when the market for biotech companies plummeted. At that time, companies were smaller and less mature than they are today, and the only biotech index at the time – the Nasdaq Biotech Index (NBI) – was down 75 per cent during the period 2000-03.

In June 2022, the NBI was down at most 39 per cent since its February 2021 peak. Today the index is dominated by the first generation of big mature US biotech companies such as Amgen, Gilead and Biogen, which are more like large pharma companies, with earnings and cash flow. As a group, they are relatively cheap. Like pharma companies, they have benefited from the stock market's rotation from growth to value stocks during 2022.

Healthcare among the best S&P 500 sectors for more than 40 years

	1980-1989	1990-1999	2000-2009	2010-2020	2021-2022
S&P 500 Index	227%	316%	-24%	190%	1%
S&P 500 Healthcare	335%	350%	11%	228%	13%
S&P 500 IT	71%	1148%	-54%	335%	-3%
S&P 500 Energy	162%	132%	102%	6%	91%
S&P 500 Financials	173%	323%	-40%	164%	7%
S&P 500 Industrials	185%	264%	-11%	183%	-1%
S&P 500 Consumer Staples	564%	234%	32%	136%	8%
S&P 500 Consumer Discretionary	287%	230%	-21%	320%	-17%
S&P 500 Utilities	115%	37%	11%	108%	12%
S&P 500 Materials	164%	105%	25%	93%	2%
S&P 500 Communication	132%	223%	-64%	58%	-16%
Nasdaq Biotech Index (start 1993)		346%	-4%	349%	-21%

Source: Bloomberg

There are a number of similarities between 2021-22 and the dot-com crash of 2000-03, which also hit mostly growth companies. This was after the roaring '90s, which included an IT boom and numerous initial public offers (IPOs). "Clicks not bricks" was the slogan back then. During the 2020-21 COVID pandemic, zero interest rates and fiscal stimulus created a surge of liquidity that sought out risk assets. Innovation and technology were all the rage; it was more important to gain future market share and be first out than have profits now. Apps, social media and big data were supposed to transform all kinds of old-fashioned industries into fast-growing gazelles. Low interest rates also made it possible to rely on high valuations. The biotech sector saw a wave of IPOs, some of which were clearly not ready for listing. This classic oversupply bubble has now burst, and even good companies have been dragged down in the sell-off. Apart from this oversupply, we do not yet have in place the conditions that usually kick-start interest in biotech companies – spectacularly good data, high takeover bids and a lot of regulatory product approvals. However, in 2022 some acquisitions have been carried out and, since valuations are attractive, the sector should be nearing the bottom while good clinical data may come at any time.

Small biotech companies have become extremely cheap

During the next few years, many big pharma companies have significant drug patent expirations that must be offset by new medicines. Analyst Michael Yee at Jefferies has calculated that the 20 biggest pharma companies have around USD 300 billion in their coffers – money primarily intended to create new growth in these companies. Combining the valuations of all the US listed biotech companies with a market value of less than USD 5 billion, the total is USD 350 billion. Pfizer alone is sitting on USD 100 billion in cash. Big Pharma can thus buy up all the small and mid-sized listed biotech companies in cash if they want.

Down 70% since the peak

Source: Bloomberg

The downturn of the past couple of years has mainly affected small biotech companies (green curve). Because of the upturn in recent months, large companies (yellow curve) have again risen above their 200-day moving average (blue curve), which is often a buy signal. Small companies are close to breaking through.

> *"Big pharma can thus buy up all the small and mid-sized listed biotech companies in cash if they want."*

Naturally, pharma companies will be selective in their acquisitions and will not buy everything. It is often said that good companies are bought, not sold. Science usually tops the wish list of big companies. In other words, the price is secondary if a company thinks that the research it is buying is of great value and has patent protection, which is crucial to enable it to recoup its investment. Items on their wish list are: 1) proof-of-concept, that is, proof of a drug's efficacy, preferably on humans, 2) large-scale studies (they provide better knowledge about the drug's efficacy and side effects), 3) strong patent protection, 4) great commercial potential (which is linked to some major medical need and limited competition), and 5) sales synergies with its existing portfolio. If the product has already been approved or is already on the market, it is de-risked and thus usually easy to price. One example among many is Pfizer's purchase of Biohaven this year for USD 11.6 billion. Biohaven developed an effective pill for migraines in a class of substances that primarily includes injectable products. Biohaven had great success with its global launch of the pill despite the pandemic, and Pfizer bought the company at a 78 per cent premium. There is also speculation that Merck will buy the company Seagen for around USD 40 billion. That would be the sector's largest acquisition since AstraZeneca bought Alexion for about the same amount in 2021.

Megatrends create favourable conditions for biotech companies

Medical needs, an ageing population, geographic expansion and patent protection are cornerstones for the industry, and there is still a great need for new innovative drugs, something the pandemic in particular has shown us. The development of the mRNA COVID-19 vaccine is one of many technological leaps revolutionising the industry. Another area that has developed at an astonishing pace is cell-based therapies (CAR-T cells, NK cells, stem cells). Cells are taken from the body and treated in various ways, for example with gene splicing (CRISPR/Cas9), and the modified cells are then returned to the body in order to hopefully cure cancer or repair a genetic defect. Gilead Sciences, Novartis, Bristol Myers Squibb and Johnson & Johnson have all launched cell-based cancer CAR-T therapies in the past 24 months. It is noteworthy that many of these therapies were developed by smaller biotech companies, which these pharma giants in-licenced the product from, and then often acquired. For example, Gilead bought Kite Pharma, and Johnson & Johnson launched CARVYKTI in 2017, in-licencing the CAR-T therapy from its Chinese partner Legend Biotech.

Major health scourges such as Alzheimer's disease, Parkinson's disease, depression, chronic pain, diabetes, obesity and cancer still need new solutions. Over the next 12 months, we will see three large-scale trials that will confirm or refute once and for all the hypothesis that amyloid beta, a protein found in all brains but which may function abnormally, causes Alzheimer's. These trials carry a high risk, but if they were to work, interest in the sector would definitely increase.

These clinical trials are all large-scale and well-controlled and should provide clear answers as to whether the treatments work, unlike previous trials in this field. It has been extremely difficult to develop drugs for Alzheimer's patients since 1) no one knows what causes the disease, 2) it is difficult to diagnose the disease, since a little forgetfulness is a natural part of ageing, 3) trials probably must be made early in the course of the disease, that is, almost before the patient has any difficulty, in order to prevent neural networks from starting to break down. Disease diagnostics are improving – with both blood-based analysis and various brain imaging methods – which is crucial for continued studies. Autopsy findings indicate that nearly 30 per cent of patients were misdiagnosed as having Alzheimer's based on current methods.

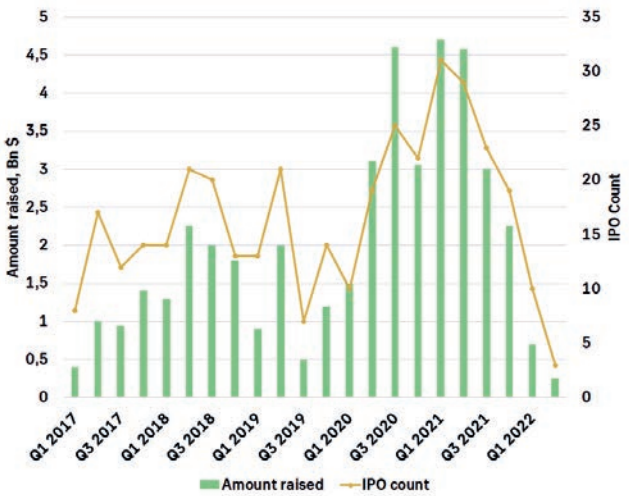
"There has been exceptional progress over the past 30 years, but the next 10 years will be really exciting."

Advances are coming at a record pace

Materials development, miniaturisation and digitisation are giving rise to new products in health technology and analysis. The diagnosis field in particular is making major advances. Numerous companies are working to develop blood-based tests for cancer diagnosis. It is far easier and cheaper to take a blood test than to perform a mammogram, colonoscopy or imaging test for cancer screening. Using so-called genetic sequencing, small bits of tumour tissue found in the blood can be analysed to identify abnormalities.

Another example of a health tech innovation is sensors that can measure the blood sugar of diabetes patients in real time. Using Bluetooth technology, data can be sent by mobile phone, and the insulin dose can then be regulated more optimally. The system can also issue an alert and thus save the patient's life should that person fall into a diabetic coma. US-based Dexcom has the leading sensor in the market, while smaller companies such as Insulet and Tandem Therapeutics have developed small wearable systems that try to mimic the body's natural insulin secretions like an artificial pancreas. These sensors can prevent the long-term damage that occurs when blood sugar is not kept in check, such as blindness, amputations, leg ulcers, loss of sensation and premature death.

The oversupply bubble has burst



Source: Evaluate

The chart shows the number of biotech company IPOs per quarter on Western stock exchanges. The biotech sector saw a wave of initial public offerings in 2021-22, and this classic oversupply bubble has now burst, with even good companies being dragged down in the sell-off.

Big data, artificial intelligence (AI) and biotechnology are revolutionising the development of pharmaceuticals. DeepMind, a British AI company acquired by Google in 2014, has managed to tackle one of the greatest biological challenges – predicting the three-dimensional structure of a protein from its amino acid sequence. There have been attempts to resolve this since the 1970s, and this solution will fundamentally change biochemistry. For the first time, it will be possible to predict what the end product – the protein – will look like based on genetic (DNA) sequencing, with the protein's 3D structure determining its function. It will be possible to use this technology in all kinds of research contexts – pharmaceutical research, materials technology, plant breeding etc. Complex biological relationships and molecules can be simulated, thus accelerating the development of medicines.

Innovations have been changing health care for decades, but new technology, new materials and the mapping of human genomes have turbo-charged developments. There has been exceptional progress in cancer treatments, vaccines, cardiovascular disease, schizophrenia, depression, diabetes, diagnostics and inflammatory diseases over the past 30 years, but the next 10 years will be really exciting. Solutions are still needed, especially for brain diseases – everything from Alzheimer's to treatment-resistant depression.
The world also has a new threat in the form of antibiotic resistance, which is becoming a lethal problem. Another exciting new field involves understanding ageing and how diseases of ageing can be slowed. Some 80 per cent of all health care is consumed during the last 20 years of a person's life, which is costly for society and naturally even worse for the individual. We all want to live a long life, but a healthy one.

The odds of successfully developing a drug are extremely slim. A drug in the first phase of its development (called Phase I, when mainly side effects are studied) has only a 10 per cent chance of coming to market. Some 90 per cent fail due to their side effects or insufficient efficacy in treating the disease. To improve their chances, investors should wait until the drug has undergone further testing. In Phase III, 30-40 per cent fail as well, and even after a drug receives marketing authorisation, it may be a commercial failure. Diversifying company risk is thus key, and the expression "don't put all your eggs in one basket" is highly relevant in the biotech sector. Investing in a fund automatically provides diversification of company risk across various therapy fields and phases of maturity, as well as exposure to the big US biotech sector.

In terms of regulatory compliance, the pharmaceutical industry is probably the best in the world. Manufacturing and research must undergo quality assurance testing and cross-checks. One positive side effect is that the sector is very ESG-friendly. The areas with room for improvement are gender equality at the executive management level and drug pricing. However, the pricing issue is usually resolved when the patent term expires, which averages about 10 years after product launch.

Summary

During the pandemic years of 2020-21, easy money drove a large number of new biotech companies into the stock market, inflating valuations. Since February 2021 this bubble has burst, and valuations are now down to levels not seen in a number of years. Many companies will not manage to obtain financing and survive, but those with good products or a good research platform will be able to raise money or be acquired. There is a particularly great need for good research and new products, while advances in new technologies, big data and the mapping of human genomes are proceeding at record speed. Despite challenges, there are many indications that the 2020s will be the decade of biotechnology.

Theme: Transition
A state of constant change

To limit global warming to 1.5° C, the world will need to make the fastest economic transition in history. This will require significant investments, not least to transform current business models. Carbon dioxide emissions must be cut in order to reduce climate change. The energy sector plays an absolutely crucial role in fighting climate change, and as investors we must support the transition from fossil fuels to renewable energy.

As far back as 2017, the International Energy Agency (IEA) estimated that the transition to a low-carbon economy will require USD 4 trillion of annual investments in the energy sector for decades to come, a pace that has scarcely slowed since then. But it also requires major changes and investments in other sectors. The IEA's scenario notes, among other changes, that 70 per cent of new cars that are manufactured must be electric and the construction industry must reduce its carbon intensity by 80 per cent.

Two critical areas for a successful climate transition are global energy production and supply, especially given the current geopolitical situation. Clearly, the use of fossil fuels in our economic system – including our dependence on undemocratic countries like Russia – has now created almost unmanageable costs for society in the short term. The energy sector accounts for nearly 75 per cent of the emissions that have raised the global average temperature since the pre-industrial era, with significant repercussions for our weather and climate. At the same time, energy is closely associated with supporting and meeting the needs of a global population that will grow by around two billion people by 2050. Rising incomes will increase the demand for energy services. Many emerging markets will navigate through energy- and emissions-intensive periods of urbanisation and industrialisation.

Meanwhile, the world's remaining carbon budget to achieve this 1.5° C goal continues to be used up faster than expected. In 2011, scientists estimated that there was an 80 per cent chance that the global average temperature increase on Earth would remain within a 2° C range, whereas today there is a 66 per cent likelihood that we will meet the 1.5° C goal. Last year (2021), the global average temperature rise had already reached 1.1 degrees, with some regions hit disproportionately hard. Thus over the past decade, the remaining carbon budget has been nearly halved. The transition in the energy sector and in many other fossil fuel-intensive industries has been slow, but there are positive signs that progress is being made, driven mainly by three factors:

- Strategic measures from political leaders and companies in the climate change field
- Net zero emissions commitments from owners and managers of financial assets
- Technological innovations that create more competitive, cheap renewable electricity production

The pressure on our energy systems that the world is now experiencing will probably not change in the short term. Yet by making conscious choices as investors, we can further help to accelerate the transition.

A successful transition requires in-depth analysis

Below is a review of how our fund management company, SEB Investment Management, identifies and invests in companies that have an interesting transition journey ahead. As part of the Net Zero Asset Managers initiative – an international group of asset managers that includes SEB Investment Management – we support the goal of net zero greenhouse gas emissions and strive to reallocate the assets under our management in line with worldwide efforts to limit global warming to 1.5° C.

> *"We do not believe that the only success factor in achieving a climate-neutral economy is to exclude all sectors with high climate risks."*

Carbon dioxide emissions in the real economy are the key to success in this effort, so our strategic approach in our transition methodology is largely focused on the energy and power utilities sectors. However, the risks associated with the energy transition affect not only electricity producers but the entire value chain. A large number of financial market participants, such as banks, asset managers, insurance companies and accountants, have direct or indirect income from these sectors and are thus also exposed to transition risks. This is mostly in the form of exposure to stranded assets – "brown" assets that may become worthless in the future – or potential regulatory risks that may suddenly change the playing field.

When we identify transition companies, we are thus not looking for companies that make marginal improvements from an environmental perspective or companies that are at the cutting edge today. We do not believe that the only success factor for achieving a climate-neutral economy is to exclude all sectors with high climate risks. We will probably need fossil-based products and services for a long while ahead. The transition journey we are trying to capture is instead a matter of finding companies undergoing a major environmental shift in their operations and business model. We are looking for companies that strive to be more dynamic, transparent and focused on innovation through carefully planned financial investments and clear strategic measures for their transition. These principles apply to all sectors, not just fossil fuel-intensive sectors, and we believe that based on our transition analysis, it will be easier for us to identify which companies have the necessary preparedness to transform their business and thus benefit in the long term.

Assessment methodology

A great deal has been written about how to assess transition companies. This is a complex form of analysis that continuously changes due to new research, the market situation, the performance of companies and changes in society.

However, there are a few basic requirements that companies must meet in order to be included in our transition assessment. The company must:

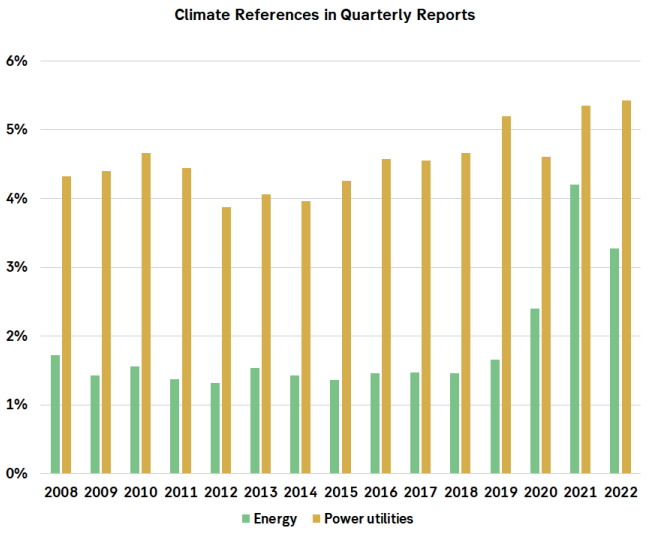
- Through its conduct, meet the minimum requirements of our sustainability policy
- Have high climate risks and positive momentum for making the transition, that is, it must have already begun its transition journey
- Have an existing plan to reduce carbon dioxide emissions within a measurable period of time that is also linked to the company's transition strategy
- Be open to dialogue with investors about its transition work

Companies are assessed individually and reviewed annually by an independent committee before they can be included in the *SEB Investment Management Transition List.* We evaluate transition companies based on three factors: their strategic willingness, their operational preparedness (capability) and actual measures (investments) to transform their business model.

Strategic willingness – the company's approach to transition

We have recently noted that companies have increased their communication about sustainability and the climate change transition, both in presentations to investors and in annual reports. This has been especially apparent in the energy sector, where a number of companies have aggressively pushed an agenda to switch to clean energy. Given some dubious climate change measures – for example, lobbying activities against the transition and greenwashing from companies in the sector – it is thus necessary to objectively assess their investment behaviour.

Companies have increased their communication about sustainability and transition



Source: SEB IM Quant Equities, 2022

Climate references have increased drastically in companies' annual reports, but also in their quarterly reports.

The key components in our assessment of strategic willingness are a company's emission reduction goals relative to regulations and agreements in effect as well as the management's actual commitment and assessment of progress. Above all, it is important to question whether their strategic goals are relevant to the necessary transition. The company's emissions under Scope, 1, 2 and 3 of the Greenhouse Gas (GHG) Protocol are thus important factors to focus on. Scope 1 is direct emissions from production, Scope 2 is indirect emissions such as from electricity, heating and cooling, and Scope 3 is indirect emissions outside the company, such as emissions from using the company's products or from manufacturing materials used in the company's production. In some cases, companies want to be exempt from disclosing Scope 3 emissions because of insufficient control over and lack of data on the use of their products. In reality, however, their business model is fundamentally dependent on these emissions. An analysis of the company's compliance with and awareness of the 1.5° C goal is therefore of the utmost importance given the above discussion.

The results of our analysis show that many companies include only Scope 1 and Scope 2 emissions, but exclude the more substantial Scope 3 emissions. For most companies, Scope 3 emissions are highest. Unfortunately, some companies that have limited themselves to reporting Scope 1 and 2 emissions nonetheless describe themselves as having "net zero emission goals". In other words, these companies plan to reduce greenhouse gas emissions intensity in their operations but not change their main business model and diversify by using low-carbon energy sources. Many companies in the energy sector fail to achieve their goals and do not meet our requirements for good strategic willingness for the following three reasons:

1. The planned emissions reduction is not enough to have an impact on climate change.
2. The reduction aimed for does not include all of the company's emissions, for example, Scope 3.
3. The investment plan is insufficient relative to the need to switch to low-carbon assets.

Operational preparedness – capability

Every company has different conditions that directly affect what its individual transition journey looks like. We take most company-specific factors into account when we analyse operational preparedness. In the energy and utilities sectors, the three most important factors are:

1. Assets: What kinds of assets does the company have? We take into account the production and power plant capacity of an energy company or electricity grid operator.
2. Revenue: What share of operating revenue is considered brown, transition-related or green? As a basis of analysis, nuclear, wind, solar and hydro power are usually classified as energy transition alternatives and thus generate green revenue, whereas fossil revenue is classified as brown.
3. Emissions intensity: What is the company's position relative to the industry's average carbon intensity today and what is its emissions intensity target? Is the company a climate change leader or does it lag behind its industry peers?

Given our strategic positioning on net zero emissions in our portfolios through 2040, it is important that we set clear limits even now for what risks we are willing to take and how much we believe in the company's willingness to change compared to what its operational preparedness looks like. That means we must begin and end our analysis of the company's operational preparedness by analysing individual company-specific assets and the company's revenue generation. In light of today's global climate challenge, combined with the fact that – for many companies in the sectors noted above – investments are not being targeted in the right direction and their measures for the transition to renewable energy are counterproductive, we have very strict rules about what levels of brown and green revenue as well as what assets these companies can have.

Example of metrics and company goals

Company	Scope of strategic carbon dioxide commitment	End use emissions	Short-term goal (2030)	Full scope 1-2-3	2030 reduction target	Net zero goal
BP	Emissions of upstream oil and gas products	Yes	Yes	Partial	35-40%	2050
Shell	Emissions intensity of all energy products	Yes	No clear goal	Partial	No goal	2050*
Chevron	Emissions intensity of all products	Yes	No clear goal	Partial	No goal	No goal
Exxon Mobile	Operational emissions intensity	No goal	No clear goal	Partial	No goal	2050**

*Shell's emission reductions to reach its respective net zero goals include expected reductions made by consumers.
**Only operational

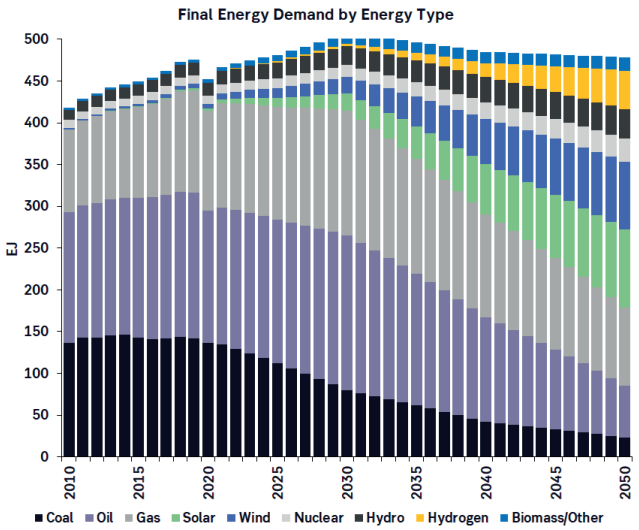
Source: Company reports, Bloomberg, Carbon Tracker

Taking a general perspective, it is clear that energy companies generally set very limited ultimate goals for carbon dioxide emissions and are not sufficiently transparent about their goal-setting processes.

As a starting point, a maximum 50 per cent of revenue may come from fossil fuels. Companies that do not meet this criterion will most likely not be included in our potential investment segment.

The next step in our analysis is to consider how a specific company's assets compare to the IEA's Net Zero Scenario. Our analysis suggests that, if the world is to achieve its climate goals, significant progress must still be made in phasing out coal and other fossil fuels while renewable capacity must be increased. To achieve the 1.5° C goal, we will not even be able to extract today's known fossil fuel reserves.

Energy mix in 2050 in a 1.5 degree scenario



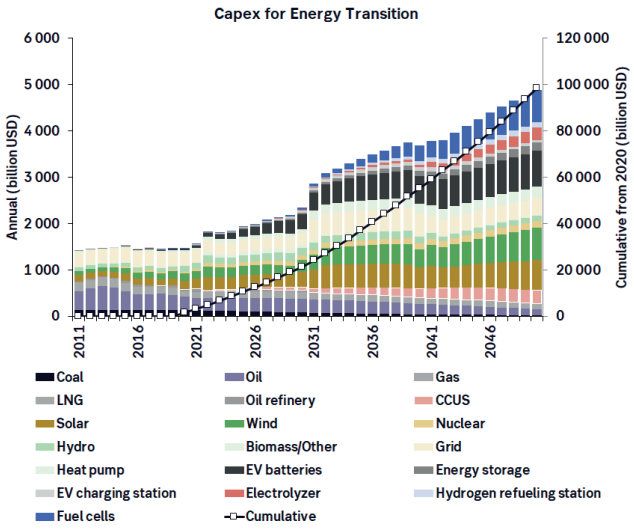
Source: IEA

The global energy mix needs to change drastically by 2050 if the world is to succeed in limiting global warming to 1.5° C. Fossil fuels in the energy mix must be reduced drastically while renewables, biomass and nuclear power need to increase.

Actual measures – investments that support the transition

In the final step of our analysis, we assess whether a company's transition is actually proceeding according to its strategic plan, taking into account the company's specific challenges related to its assets and revenue today. This is a challenging task since it is difficult to assign values and identify the company's journey based on the financial data that is available. We expect our transition companies to have a clear financial commitment behind their strategic plans and to be serious about making the transition and investing to meet the 1.5° C goal. Based on the IEA's Net Zero Scenario, we know there is an enormous need for capital expenditure (CAPEX) for the global energy transition. As shown in the chart below, investment costs associated with the transition are forecast to be rather large globally, USD 100 trillion. It is also clear that investments need to increase in all segments of the energy sector that can make the transition. There is good awareness in the power utilities sector of the need for investments; 80 per cent of total transition-related investments are made in the power utilities sector, whereas the oil and gas sector lags behind. Although sky-high fuel prices have produced totally unforeseen tailwinds for oil and gas, a very small percentage of these companies' financial investments are being made in the necessary transition to a low-carbon economy.

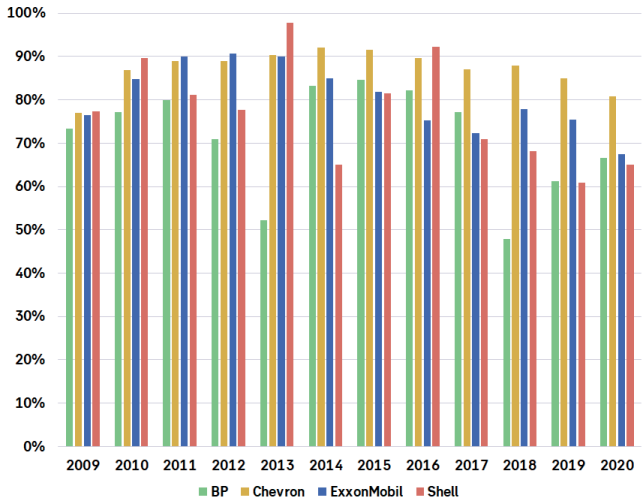
Energy transition requires investments



Source: Bernstein's Equity Research

A projection by Bernstein, an investment bank, shows a very large need for capital expenditure (CAPEX) in renewable energy sources going forward.

Large-scale investments in fossil fuels



Source: Company reports, FactSet, S&P

The major energy companies are still investing mainly in fossil fuels, but that percentage looks like it is starting to shrink.

The core of our assessment of the company's measures is thus analysing the relation between investments to develop present-day fossil-based revenue and investments to develop revenue streams in low-carbon assets such as solar and wind power. We divide up spending into capital expenditure (CAPEX) and operating expenditure (OPEX) and identify what share of a company's investments/expenditures support the transition. Looking at significant operators in the oil and gas sector, we can easily reach the conclusion that a large share of the sector's investments do not support the scenario of a 1.5° C temperature rise.

For that reason, many companies are excluded from our transition list. We understand that these companies cannot cut off all revenue generated by fossil fuels or change their business models overnight. We are aware that many emerging markets rely on a relatively cheap energy supply. At the same time, the world has never faced the challenges we have today, and time is running out. When a company generates more than 90 per cent of its revenue from an asset class not suited to a world with an average temperature rise of 1.5° C, and when we can see that 80 per cent or more of its CAPEX is spent on new exploration, it is not easy to see a scenario where it can meet its strategic commitments or make the transition from its present-day revenue streams. These kinds of companies quite simply cannot be classified as transition companies, and we are even more dubious about the strategic positioning of many energy companies. Have they really understood the challenges that lie ahead of them?

Conclusion – there is no time left to experiment

The energy transition is both necessary and feasible but will require global mobilisation, which includes financial market participants. Solutions will need to be scaled up and invested in, while existing "unsustainable" sectors will become "greener". The greening process will be gradual and is based primarily on identifying companies that to a great extent help, or strive to help, achieve the goals that have been established. Things are moving quickly. Our methodology is not definitive and will be adjusted over time. We understand that not all the companies classified today as transition companies will be transition companies tomorrow. However, our endeavour to understand the transition plans of these companies is crucial in order for us to assess whether the companies we invest in include climate risks in their calculations and undertake relevant measures. We are also aware that there will always be a discrepancy between what companies claim and what they actually do. It is therefore important that we as investors can have an open, transparent dialogue with companies about strategic willingness, operational preparedness and responsible company-specific investment measures. A transition company in our investment universe no longer has the option, or time, to simply experiment. It only has time to act.

Theme: China

Growth takes backseat to COVID policy

Because of China's troubled real estate sector and economically devastating COVID strategy, the country's once optimistic growth target has taken a real beating. Chinese policymakers have finally signalled flexibility on their economic targets. However, this will require additional policy support in order for the economy to stabilise, which we expect will be provided.

China's Politburo finally downplayed its ambitious growth target for 2022. Failing to mention the 5.5 per cent target at their quarterly meeting in late July, policymakers have signalled some flexibility. This eased pressure on local governments heavily impacted by COVID containment measures. The policy response is still restrained, however, reflecting Beijing's lingering caution about flooding the economy with too much stimulus. We have thus revised our GDP growth outlook to no more than 3.5 per cent for 2022, before it rises to 5.3 per cent in 2023.

Key data

Year-on-year percentage change

	2021	2022	2023	2024
GDP	8.1	3.5	5.3	5.0
CPI	0.9	2.4	2.3	2.1
Fiscal balance*	-3.8	-4.9	-4.5	-4.0
Bank reserve req.**	11.5	11.25	10.75	10.75
1-year prime loan rate**	3.80	3.60	3.60	3.60
7-day reverse repo rate**	2.20	2.00	2.00	2.00
USD/CNY**	6.36	6.85	6.65	6.30

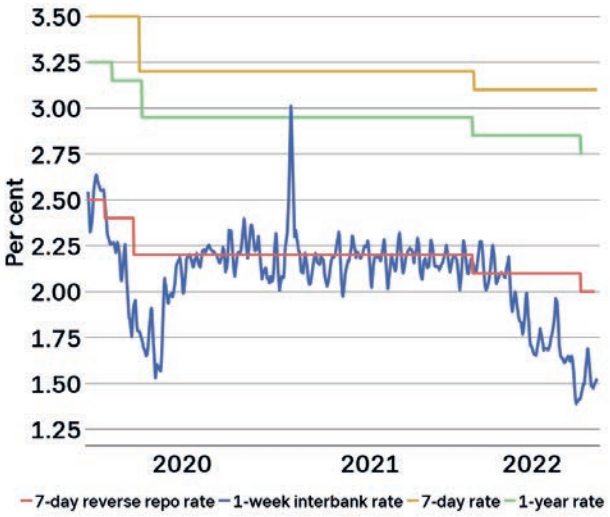
*% of GDP. **at year-end

Source: IMF, SEB

China's COVID containment policy is still the strongest threat to growth. While COVID infections in the biggest cities remain contained after the re-opening of Shanghai, the omicron variant has spread to other localities. This has led to rolling lockdowns in different parts of the country, keeping consumer sentiment soft. Although urban unemployment has continued to fall, retail spending has still been weak. If this COVID policy is not eased, consumer spending will most likely not recover for a long while.

July's slowdown in economic activity triggered an immediate adjustment in monetary policy, with the People's Bank of China delivering cuts in a number of key interest rates. That included a 15 basis point cut in its 5-year loan prime rate (LPR), the reference rate for mortgages, to 4.30 per cent (lower chart) – the third reduction in the 5-year LPR this year, for a cumulative reduction of 35 bps so far in 2022, a big change by Chinese standards. The more aggressive 5-year LPR cuts reflect policymakers' intention to stabilise the troubled real estate sector. This adjustment will further push down average mortgage rates, since the minimum mortgage rate is set at 20 bps below the 5-year LPR.
Yet even before the latest rate cuts, financial conditions had been easing for months. The PBoC has been guiding interbank funding lower via liquidity injections. While lower borrowing costs are designed to prop up demand for credit, expansionary monetary policy has not yet been able to limit the deterioration in Chinese economic confidence.

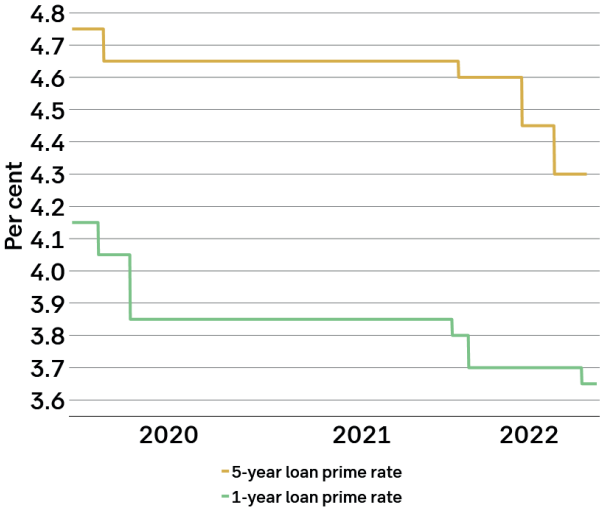
PBoC is going its own way with policy easing



Source: PBoC, China FX Trade System, Macrobond, SEB

The People's Bank of China (PBoC) has lowered a number of its key interest rates in several rounds, also using various methods to bring down the interbank rate.

Lower long-term rates



Source: PBoC, China FX Trade System, Macrobond, SEB

Long-term key rates have also been lowered in order to help stabilise the real estate sector.

Fiscal policy is stimulative

Weaker than expected economic activity in July prompted policymakers to announce fiscal and administrative support to stimulate domestic demand. On top of previously announced stimulus packages, Premier Li Keqiang unveiled a new CNY 1 trillion financial plan focused on infrastructure investments. Included in the 19 new measures is another CNY 300 billion that state-owned banks can allocate to infrastructure projects, in addition to the CNY 300 billion in funding announced in June. State-owned power companies will be backed in issuing CNY 200 billion in special bonds to invest in power capacity. Local governments will also be allowed to issue CNY 500 billion in special purpose bonds, tapping previously unused quotas. The new allocation of bonds to local governments must be issued by the end of October and will be on top of the CNY 3.65 trillion quota planned for 2022. While the new stimulus package will help to increase investment by local governments to some extent, the total amount of unused quotas is estimated to be around CNY 1.5 trillion. Beijing is thus releasing only a third of funding available for local governments. While the central government is keen to stabilise domestic demand, it is wary about flooding the economy with more support than it can effectively absorb.

Growth-promoting measures designed to stimulate consumption include tax exemptions on purchases of "new energy" vehicles, which will be extended until the end of 2023. The government will also arrange more fiscal policy tools to increase the sale of electric vehicles and improve charging infrastructure.

Continued problems in the real estate sector

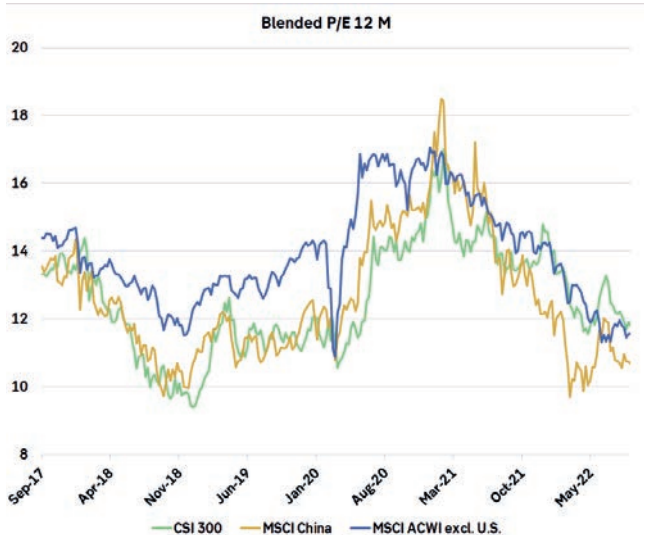
The crisis of confidence in the housing market continues. Construction activity continues to fall, which confirms that property developers are failing to delivery pre-sold homes. Recently published earnings reports indicate that state-owned banks have doubled their overdue loan estimates in conjunction with mortgage boycotts by homeowners. Meanwhile, China's largest state-owned asset management companies (AMCs), which manage bad debts, reported falling earnings due to credit impairments related to their property exposure. The ability of these AMCs to act as white knights for the real estate sector may be limited unless Beijing steps in with fresh capital. This increases the pressure on decision makers to ensure that pre-sold housing developments are completed. Aside from the substantial reduction in mortgage-related interest rates, the central bank has also announced CNY 200 billion in special loans to property developers. These special loans will only be available for pre-sold and uncompleted projects. This is the biggest financial commitment so far from Beijing to stabilise the real estate sector.

Scope for a stronger yuan

Despite the dollar's dominance, a strong trade balance will enable the USD/CNY rate to fall back to 6.85 by the end of 2022. Despite difficulties due to COVID lockdowns, China's exports have remained surprisingly robust. Exceeding USD 100 billion in July, the trade surplus year-to-date has widened to USD 492 billion compared to USD 314 billion for the same period in 2021.

The positioning of Chinese companies will also eventually slow the yuan's decline. Exporters held on to foreign currency receipts when the yuan was at its strongest. Indeed, the decline in foreign currency deposits in four of the last five months confirms that companies have sold dollars as they benefit from the weaker yuan to lock in profits. Finally, while the USD trend has been strong, some market statistics indicate the negative sentiment on the yuan has peaked. Nonetheless, the PBoC will need to weather the higher dollar before the yuan's strong fundamentals ultimately prevail.

Lower company valuations



Source: Macrobond

Chinese company valuations expressed as price-earnings ratios have fallen, especially for companies in the MSCI China index, which is dominated by the "digital dragons".

Reduced regulatory risks

Recently, the stock market has been weighed down by US threats to de-list Chinese companies from American exchanges for regulatory reasons. Regulatory uncertainty has eased somewhat after the US and China reached a preliminary agreement to allow officials to review audit documents of US-listed Chinese companies. The deal could avoid the de-listing of about 200 firms from American exchanges. The agreement marks a major breakthrough in a decades-long standoff between the two countries over access to audit documents. Combined with the clear decrease in listed company valuations, this could fuel an upturn in Chinese equities.

International overview

Mild recession amid energy and interest rate worries

Excerpt from the Nordic Outlook research report, published August 30, 2022.

For current forecasts see, research.sebgroup.com/macro-ficc

For the full report see, seb.se/nordicoutlookreport.

A worsening energy crisis, including soaring natural gas prices, is squeezing households and businesses. Rising inflation is forcing central banks to continue hiking key rates, despite mounting growth worries. We have revised our 2023 global GDP forecast down by 0.8 percentage points. Both the US and Western Europe will enter a mild recession with near-zero growth. Rising unemployment and modest long-term inflation expectations will create room for interest rate cuts further ahead, supporting a cautious recovery during 2024.

Accelerating inflation and rapid key interest rate hikes have contributed to deterioration in the global economic outlook. In the United States, GDP shrank during the first two quarters, while Chinese authorities have been forced to accept that they will not meet their ambitious growth targets for 2022. So far, Western Europe has been unexpectedly resilient, but with the energy crisis assuming increasingly dramatic forms and with no end to the Ukraine war in sight, a consumption-driven slowdown looks inevitable this autumn. Overall, we have revised our GDP forecasts sharply lower, especially for 2023. Over our entire forecast period, our revisions are largest for the US, but the outlook for 2023 has changed most in Western Europe. Next year we expect GDP growth of only 0.9 per cent in advanced economies (the 38 OECD countries), compared to 2.3 per cent in our May forecast. In emerging market (EM) economies, the trajectory is different. China's recovery will slightly accelerate growth in our EM sphere in 2023, helping to smooth the global GDP curve, which will reach a year-on-year low of 2.6 per cent in 2023.

Only a mild recession

Our forecasts are generally more pessimistic than the current market consensus. In both the US and Western Europe, we expect GDP to fall during the second half of 2022, and unemployment is climbing. But several factors suggest that we are facing a relatively mild recession. There are still post-pandemic savings buffers that can be used for pent-up consumption needs. Underlying financial imbalances are nowhere near as large as during the global financial crisis (GFC) in 2008-2009. A deep, protracted balance sheet recession can thus be avoided. Labour markets have been very resilient so far. Although they are now expected to deteriorate, the upturn in unemployment will be relatively limited, reducing the risks of a sharp drop in consumption. Another positive factor is that we now see an easing of disruptions in global supply chains.

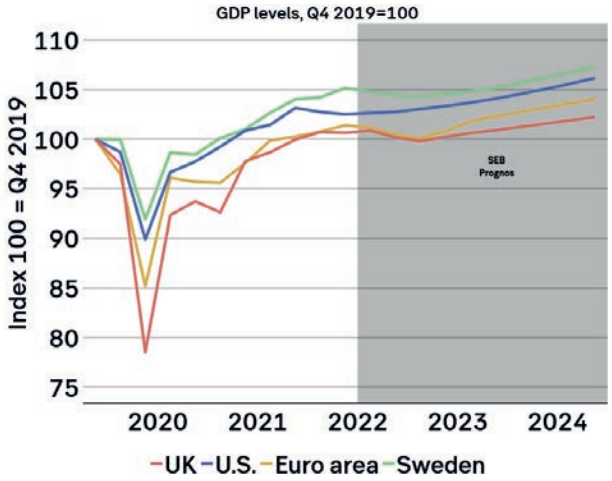
Global GDP growth, year-on-year percentage change

Markets	2021	2022	2023	2024
United States	5.7	1.5	0.5	2.0
Japan	1.7	1.9	1.6	1.1
Germany	2.6	1.3	-0.1	2.5
China	8.1	3.5	5.3	5.0
United Kingdom	7.4	3.4	-0.2	1.3
Euro area	5.3	2.7	0.3	2.1
Nordic countries	4.4	2.3	0.5	1.9
Sweden	5.1	2.0	0.1	1.7
Baltic countries	5.6	1.5	1.2	3.4
OECD	5.4	2.4	0.9	2.2
Emerging markets	6.7	3.6	3.9	5.4
World, PPP*	**6.1**	**3.1**	**2.6**	**4.0**

Source: SEB Nordic Outlook

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

Mild recession ahead



Source: Macrobond , SEB

We expect slightly negative growth in the next few quarters, especially in the UK and the euro area, where the recovery has also been weaker. In the course of 2023, growth will rebound.

Economic policy challenges

Central banks are now being forced to prioritise inflation-fighting despite the economic slowdown, in order to prevent long-term inflation expectations from soaring. Fiscal policymakers also face a dilemma, especially in Europe. They must launch extensive programmes to soften the acute impact of extreme energy prices, yet such programmes must meanwhile not unduly hamper the efforts of central banks to fight inflation. Support measures will probably have some distorting consequences, such as slowing the green energy transition, but we see good potential for a relatively successful balancing act.

The hiking cycle is almost over

In the short term, runaway energy prices are contributing to major upward revisions in European inflation forecasts. We will see double-digit inflation in the euro area and the United Kingdom this winter, even though some support measures are designed to significantly dampen CPI inflation in many euro area countries. Secondary effects such as compensatory wage hikes will contribute to elevated inflation a bit further ahead as well. But the central bank hiking cycle will probably soon be over. Our forecast is for the US Federal Reserve's key rate to peak at 3.50 per cent at the end of 2022, with central banks in Western Europe ending their hiking cycles at around 2-3 per cent in early 2023. Some months into 2023, labour markets will probably have cooled off quite noticeably. Although the fall in inflation will be sluggish, confidence in central bank targets is likely to strengthen once the downward trend becomes clear. The upturn in long-term inflation expectations has been fairly modest, which also suggests only limited market worries that we are heading into a totally new inflation environment. We thus foresee room for rate cuts late in our forecast period. Such a monetary policy pattern between now and the end of 2024 will provide support to both the economy and asset prices ahead, though there are major challenges during the coming year.

Long-term yields close to peaking

After a volatile summer, we expect bond yields to rebound this autumn, but without surpassing their June highs. Ten-year US Treasuries will peak at 3.30 per cent just before the Fed ends its hiking cycle in late 2022. German 10-year yields will keep climbing in 2023, reaching 1.75 per cent by year-end. Quantitative tightening (QT) by the Fed and the end to the European Central Bank's quantitative easing (QE) programme will contribute to slightly higher long-term yields. As key rate cuts approach, bond yields will start to fall. By late 2024, 10-year US Treasuries will yield 2.60 per cent and their German equivalents 1.60 per cent. The spread between Swedish and German 10-year bonds narrowed greatly this summer but is expected to widen somewhat in the coming year as the Riksbank both stops its bond purchases and hikes its key rate more than the ECB.

The US dollar will remain strong for another while

Subdued global growth and inflation well above central bank targets will lower risk appetite in the coming year, creating a favourable environment for defensive currencies like the USD, which is also supported by continued Fed tightening. Meanwhile Europe's deepening energy crisis is pulling down the euro, with the EUR/USD rate expected to fall to 0.95 by late 2022 before regaining some ground. The Swedish krona will also struggle in the prevailing environment, despite Riksbank rate hikes. Near term, the krona will also be weakened by Riksbank foreign currency purchases, which are expected to continue until end-2022. Then we expect the SEK to strengthen, with EUR/SEK falling from 10.55 at the end of 2022 to 10.15 by end-2023.

Energy crisis increasingly serious

The increasingly chaotic situation in European energy markets is creating unusually large challenges in our forecast. Energy futures prices now almost indicate a market collapse. Natural gas futures for the coming month are 15 times higher than historical norms. Even though reserves are approaching normal levels, the market's verdict at this stage appears to be that Europe is not capable of meeting its energy supply needs this coming winter. Industrial companies have usually hedged their prices over a long period, so the big cost increase for European firms will occur in early 2023.

Adjustment mechanisms will ease crisis over time

But we should be cautious about drawing far-reaching conclusions. High volatility and uncertainty make it hard to interpret what the market is actually pricing in. Liquidity has drastically decreased, since many financial market players no longer dare invest in these instruments. Prices will remain high for some time, but we believe it is not reasonable to rely entirely on futures prices in our forecast. We expect natural gas prices to average EUR 141 and EUR 80 per MWh in 2023 and 2024, respectively, compared to over EUR 300/MWh for contracts during the rest of 2022. Higher liquefied natural gas (LNG) imports and fossil fuel consumption, renewable energy production and efficiency-raising measures will help dampen gas prices a bit, along with lower energy demand. A bit further ahead, steps taken to reduce dependence on Russian energy will make the situation far less critical in the winter of 2023-2024. As for oil, we expect prices to average USD 115 and USD 95/barrel in 2023 and 2024, respectively, compared to USD 100 today. We will see a price uptick in 2023, partly because demand will rise when oil is so much cheaper than other energy forms. Saudi Arabia has also declared that it views the current price level as artificially low and is thus prepared to cut production.

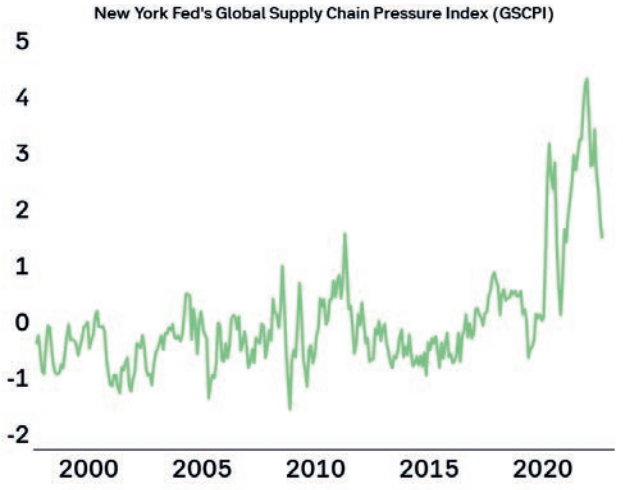
Government support will ease but distort

The energy issue currently tops the political agenda in Europe. Support in the form of tax cuts, lower fees, subsidies, price caps, etc. is helping ease the impact of high energy costs on households and businesses, but such measures destroy price signals and slow the green transition, which poses a dilemma. Today EU countries spend 1-1.5 per cent of GDP on support to households and businesses, but the risks are on the upside.

China will continue its strict COVID strategy

COVID-19 continues to spread around the world, with new virus variants. The number of infections according to World Health Organisation (WHO) statistics remains relatively high, but deaths have fallen sharply. Vaccines, anti-COVID medicines, greater experience in the health care system and milder virus variants are contributing to this. The reopening of economies this past spring after two years of more or less tight restrictions is evident in rising service consumption, for example. Yet despite successes in fighting COVID, lingering problems are hampering economies globally. China is maintaining its tough COVID policy, with recurrent regional and local shutdowns as transmission speeds up. Given the political prestige at stake, we see little prospect of a strategy change anytime soon. Beijing seems prepared to pay a price in the form of lower growth.

Easing of stress level in corporate value chains



Source: Federal Reserve Bank of New York, Macrobond , SEB

In recent years, the reopening of economies after pandemic-related lockdowns has created major global supply chain problems. These now appear to be easing.

Widespread long-term consequences

Elsewhere, too, the pandemic has had an economic impact that may be long-lasting, mainly via lower labour supply. In the US, behavioural changes are clear. For example, older people are apparently not returning to the labour force, worsening recruitment problems in many sectors. New COVID waves are affecting absences from work. In the UK, reports indicate that "long COVID" symptoms are so prevalent that they are affecting the labour supply.

The energy crisis dominates downside risks

Our main scenario implies very high prices for quite a long time, severely hampering economic activity. But an even worse scenario – where Russian gas supplies are completely cut off – cannot be ruled out, especially in light of current futures market pricing. This would force more widespread rationing in the winter and cause a much deeper recession than in our main scenario. We see governments and central banks in Europe now starting to work with such risk scenarios. Our negative scenario assumes a deepening energy crisis in Europe. The GDP decline in the countries that are most dependent on Russian energy, such as Germany and Italy, is projected at 4-5 per cent as an annual average for 2023. In the Nordic countries, we assume that GDP would fall by only around 2 per cent.

Various scenarios for the OECD countries

GDP growth, per cent	2022	2023	2024
Main scenario	2.4	0.9	2.2
Negative scenario	1.5	-1.0	1.2
Positive scenario	2.7	2.2	3.2

Source: SEB

Limited upside potential

In the current situation, it is also natural to connect the prospects for a more favourable scenario to developments in energy markets. A faster end to the Ukraine war or unexpectedly strong adaptability in Western Europe may be part of such a scenario. It is also conceivable that we are underestimating the strength of the downturn in inflation over a longer period. Downside risks still dominate growth, but after the sharp downward revisions we have already made in our main scenario, we regard the risk situation as a bit more symmetrical than before.

Public sector financial balance (% of GDP)

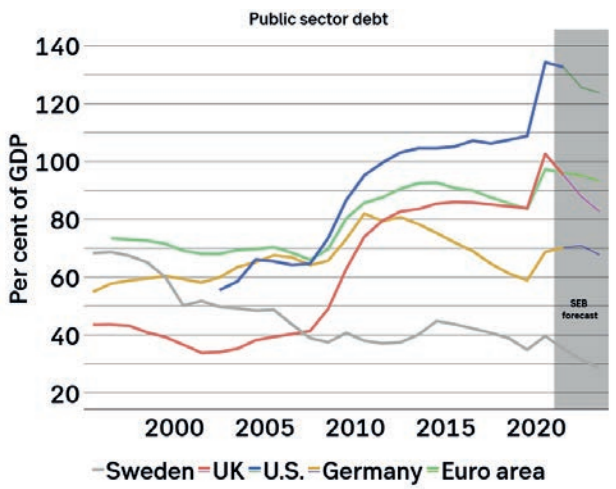
	2021	2022	2023	2024
United States	-11.0	-4.5	-5.0	-6.0
Euro area	-4.3	-3.9	-3.0	-2.5
United Kingdom	-8.0	-5.0	-3.0	-1.5
Sweden	-0.3	0.4	0.2	0.0
OECD	-8.1	-4.7	-4.0	-4.1

Source: IMF, SEB

High inflation poses a fiscal policy dilemma

During the pandemic, fiscal policymakers assumed the main responsibility for enacting stimulus measures. Given their relatively empty toolkit, central banks had to accept a supporting role, but in a stable low-inflation environment they could contribute permanently low interest rates. This seemed to lower the risks of rapidly rising public debt due to exceptionally large fiscal stimulus. Now that rapidly rising inflation is forcing central banks to impose key rate hikes, this creates a fiscal policy dilemma. On the one hand, there is a risk that stimulus programmes will exacerbate inflation problems, but at the same time there is a strong need to alleviate the consequences of soaring energy prices.

Falling debt ratios



Source: IMF, Macrobond, SEB

Because of rapid inflation and increasing tax revenues, high debt-to-GDP ratios are falling slightly in some countries.

Deficits are shrinking and debt is falling

Given the relatively cautious stimulus measures we view as the most likely, active fiscal policy is expected to be mildly expansionary in 2023-2024 – somewhat more in the EU than in the US and UK. High inflation and extreme electricity prices will drive up tax revenues (and profits of state-owned energy companies) as tax bases expand rapidly in current price terms. In countries where wage growth has speeded up, such as the UK and the US, we will see a similar effect on total wages. Fiscal deficits will actually keep falling in 2023. In a high-inflation environment, current-price GDP is growing quite fast despite real stagnation, helping push debt ratios lower.

Inflation issues in various time perspectives

The recent dominance of inflation issues is largely due to the fact that short-term developments threaten to create both medium- and long-term consequences similar to the stagflationary era of nearly 50 years ago. It is therefore appropriate to discuss the inflation outlook in a few different time perspectives.

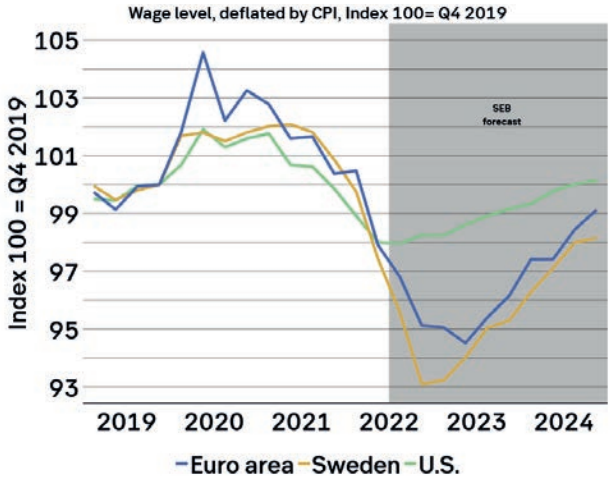
Energy prices crucial in the short term

Energy market developments continue to dominate the short-term inflation outlook. European natural gas and electricity futures point to extremely high prices this coming year. UK inflation is expected to peak at nearly 18 per cent this autumn. In the euro area, the market situation looks even more dramatic, but the structure of stimulus measures will cause inflation to peak at around 11 per cent. A sensitivity analysis shows that inflation would reach nearly 17 per cent if market prices were allowed to fully feed through as, for example, in the Netherlands. Meanwhile there are also forces that are moderating the inflation outlook. Falling demand has contributed to a decline in oil prices, with a particularly strong impact on petrol prices. There are also indications of lower price pressures for other goods in the world market, due to a weaker economic outlook and an easing of global supply chain problems. We have also seen some decline in agricultural commodity prices, partly due to resumption of export shipments from Ukraine. Overall, easing tendencies predominate in the US, while the energy crisis overshadows everything else in Europe.

Transmission patterns crucial in the medium term

The inflation trend over the next 6-18 months will be determined by how the initial shock is transmitted through the economy. In recent decades, cost impulses have typically been held back, for example via temporary narrowing of margins and productivity improvements. This time the impulse is so strong that we will see a slower transmission process that helps keep inflation up during the coming year. Many companies will be forced to raise prices when the opportunity arises, in order to survive. The degree to which prices are passed on to customers is determined by the pricing power of businesses, but we are also seeing new political efforts to influence developments. In the US, a discussion on "greedflation" has been under way for some time. In Sweden the government has commissioned the National Institute of Economic Research (NIER) to investigate the existence of "unwarranted" price hikes. In monopoly or oligopoly-like environments, such scrutiny may be justified, but there is a risk that more general attempts to influence price mechanisms may be somewhat naïve.

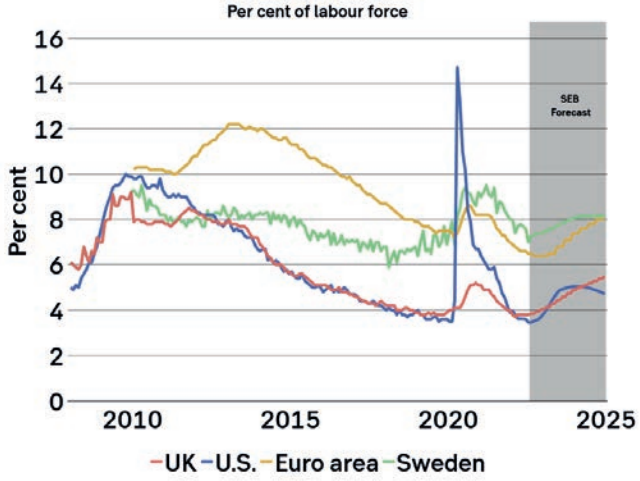
Depressed real wages



Source: Macrobond, SEB

Real wages (actual wages minus inflation) have shrunk in recent years and will continue to do so for a while, putting pressure on labour markets. This risks generating demands for compensation, potentially fuelling an inflationary wage-price spiral.

Minor upturn in unemployment



Source: Macrobond Financial AB, SEB

Especially in the US, unemployment is at historically low levels. We now expect it to climb somewhat overall, but to fall far short of the levels that prevailed after the global financial crisis of 2008-2009.

Falling real wages will create tensions

Rent hikes due to cost increases are another component that comes after a time lag, but the degree of wage compensation for inflation will be the key issue for the medium-term inflation outlook. So far, real wages have been pushed down more in the euro area and Nordics than in the US and UK, where overheated labour markets have contributed to relatively rapid pay hikes. Yet the labour conflict level has been highest in the UK, with a series of strikes and high wage demands. In Germany and the Nordics, central agreements will determine how fast real wages are restored. The scope for companies to tolerate wage hikes that compensate for inflation will be a major bone of contention in negotiations. Companies in many sectors are being squeezed by rising costs, but so far profitability has generally held up fairly well. Our forecast (see chart) implies that real wages will recover in late 2023 and in 2024, mainly due to falling inflation. But real wages at the end of our forecast period will remain below the pre-pandemic level, which thus implies a five-year period of stagnation in real wages. If real wages had followed the trend of recent decades, they would instead have risen by 7-8 per cent over this five-year period.

Brighter long-term outlook

If worries predominate in both the short and medium term, we can take a brighter view of the long term. Once transmission effects work their way through the system, base effects combined with normalisation of elevated prices will push down inflation. Historically, we have also often seen such "mirror images" on the downside after strong inflationary surges, suggesting there is actually a risk of below-target inflation late in our forecast period. Nor do long-term inflation expectations point to widespread concerns that we are entering a totally new inflationary environment. Recessionary fears may have contributed to the latest downturn, but there are also institutional factors that contribute to a far more stable low-inflation environment today compared to the early 1970s.

Long-term inflation expectations

Source: Macrobond Financial AB, SEB

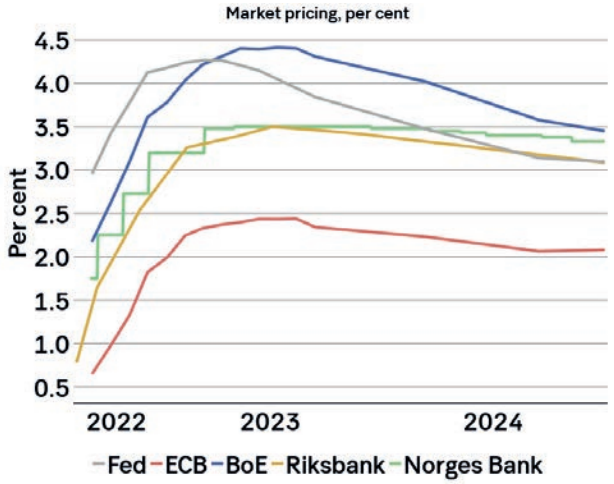
After falling for many years, long-term inflation expectations have climbed during the post-pandemic recovery to levels above central bank targets. More recently, however, they have shown some stabilisation.

Reversed monetary policy experiment

The pandemic saw the culmination of a broad monetary policy experiment that began after the GFC, employing negative interest rates and huge asset purchases. Today we are facing the reverse situation, with synchronised rate hikes while asset purchases have been replaced by balance sheet reduction (QE is being replaced by QT). In a relatively short period, central banks have thus moved from signalling that inflationary impulses are relatively temporary to viewing them as a dangerous threat. There is a broad consensus that inflation must be brought down by whatever means are available, despite ever-weakening economic conditions. Inflation is now putting severe strains on households and businesses. This increases acceptance for such a policy.

In the short term, a strong labour market also helps ensure that central banks cannot rest on their laurels. The labour market is actually a lagging indicator, but in the current environment this does not seem to be accorded so much importance.

Front-loaded expectations of rate hikes



Source: Macrobond Financial AB, SEB

Financial market players anticipate continued aggressive key interest rate hikes in the next several months but expect the Fed to set the pace of rate cuts during 2023. We largely concur with their short-term outlook but expect lower rate hikes in Sweden.

The hiking cycle will soon be over

Because central banks have now speeded up their rate hikes, the end of the hiking cycle is not far away. The Fed, which was early to raise rates, will reach 3.50 per cent in December. The central banks of the UK and Norway are also expected to end their rate hikes before the end of 2022, when they will reach 2.75 and 3.00 per cent respectively. Sweden's Riksbank, which was late out of the starting blocks, has now picked up its pace and is expected to deliver a 75 basis point hike in September followed by 50 bps in November. After a final small hike in February 2023, the repo rate will reach 2.25 per cent. Market expectations of the Riksbank's top rate have recently fallen a bit but are still about 50 bps above our forecast. The ECB, grappling with issues related to both the general outlook and the sensitivity of various economies to rate hikes, was the last to begin key rate hikes. We expect its deposit rate to peak at 1.75 per cent and the refi rate at 2.25 per cent in mid-2023. Meanwhile the ECB has developed other tools (especially the Transmission Protection Instrument, TPI) to protect weaker economies and help prevent widening yield spreads between countries.

Central bank key interest rates (per cent, December)

	Aug 25	2022	2023	2024
Federal Reserve (Fed)	2.50	3.50	3.50	2.50
ECB (deposit rate)	0.00	1.50	1.50	1.50
Bank of England (BoE)	1.75	2.75	2.75	2.25
Riksbank (Sweden)	0.75	2.00	2.00	1.75
Norges Bank (Norway)	1.75	3.00	3.00	2.25

Source: Central banks, SEB

Key rate cuts towards the end of our forecast period

Our assessment is that central banks will have some room to cut key rates late in our forecast period, once inflation has more clearly decelerated. Even if growth also rebounds at that time, the gap to the pre-pandemic trend will remain relatively wide in most economies. In the US, the resource situation looks stretched even in the longer term, especially given the indications of rising equilibrium unemployment we have recently seen. But Fed rate cuts back to a neutral level late in our forecast period are the scenario that now seems most probable.

Less impact from QT than from key rate hikes

We expect balance sheet reductions to proceed according to plans that central banks have announced, putting further upward pressure on long-term bond yields. The banks are carrying out these reductions both by allowing instruments to mature and by means of outright sales. Experience is limited, but estimates suggest that the effect of these actions on yields is far less than what is now coming from key rates. One Fed study concludes that a reduction in Fed asset holdings equivalent to USD 2.2 trillion over 3 years corresponds to a yield upturn of 30 bps. Our forecast of a reduction of nearly USD 3.5 trillion would thus be equivalent to about a 50 bp upturn under normal market conditions: roughly in line with estimates being made in various Fed statements. Overall, our view is that QT policy is less important in pushing up yields than key rates, but this conclusion may change in environments of more pronounced risk aversion. The flows generated by QT actions may amplify tendencies toward credit market stress, for example. The above study concludes that a given reduction in Fed asset holdings in the current situation has more than twice the impact on bond yields as it would in a more normal market situation.

The delayed effect dilemma

Monetary policy measures have an impact after a rather long time lag, which is creating an additional dilemma. Changes in key rates normally have their greatest effect on inflation after one or two years. At present, central banks do not have time to wait for these effects but need to hope that their willingness to fight inflation will influence long-term inflation expectations. Estimates of the neutral interest rate (where the key rate has neither a stimulative nor a tightening impact on the economy) have become more important as rate hikes have accelerated, which can probably also be linked to this dilemma. In advanced economies, the neutral level is likely to be around 2-2.5 per cent, but it varies somewhat depending on differences in underlying inflation and growth trends. Although these estimates are uncertain, they have served as a benchmark when central banks have tried to guide the market to see where they are headed in a short-term perspective.

Similarities and differences compared to the 1970s

The question of how firmly anchored long-term inflation expectations are has become increasingly important in this environment. Major international organisations such as the IMF, OECD and BIS have recently focused on this comparison. There are undeniably interesting similarities. In 1973-74, food prices also rose due to the oil price surge that OPEC managed to create. The labour market was also relatively tight at the onset of the crisis. Worth noting is that the initial

recession was relatively mild. Average unemployment in the G7 economies was only one percentage point higher in 1974-76 than in the "pre-crisis" period 1971-73, although the US upturn was close to 2 points. The epoch is thus viewed as a failure not because the downturn was especially deep, but because an inability to coordinate appropriate policy responses meant it took a long time to get back to a functioning stabilisation policy framework. In this respect, the stakes are high. If expectations of something similar now take hold, estimates of neutral interest rates would climb rapidly, with major implications for asset prices.

The differences are bigger after all

Fortunately, the differences between today and the 1970s are probably greater than the similarities. Weak international competition, frequent labour disputes and indexation of various prices and wages contributed to an environment of high, volatile inflation. The contrast with today's situation is stark. Thirty year of low inflation have created a high degree of credibility for inflation targeting, with an especially great impact on wage formation in countries where centralised labour agreements play a key role. The degree of formal price and wage indexation in business contracts has been on a downward trend for 40 years and is now almost completely gone. Despite concerns that global competitive pressures have weakened in recent years, differences compared to the 1970s are still quite large.

Growth is slowing in the EM economies

Most emerging market economies are now decelerating, in line with the global trend. This slowdown has clear recessionary features, but no clear definition exists. The underlying trend in the EM countries is too strong for the criterion of negative growth in two consecutive quarters to be relevant. High inflation is eroding household purchasing power. Together with declining growth among OECD countries, this is holding back production and employment. With rising global and local interest rates, most governments – especially in Latin America and Africa – will have less space for stimulus spending. This is also true of India, where the economy will clearly slow in 2023. We expect GDP in the EM sphere to grow by 3.6 per cent this year and 3.9 per cent in 2023, but the upturn is only due to China's recovery next year. Excluding China, EM sphere growth will fall from 3.8 per cent in 2022 to 3.1 per cent in 2023.

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

	2021	2022	2023	2024
China	8.1	3.5	5.3	5.0
India	8.3	7.4	5.8	6.5
Brazil	4.8	1.6	0.8	2.0
Russia	4.7	-4.0	-3.0	2.5
Emerging markets, total	6.7	3.6	3.9	5.4

Source: IMF, SEB

Upward revisions for Brazil and Russia

Brazil's economy has been boosted by rising commodity prices after the pandemic and during the Ukraine war, but a slowdown in global demand will probably lower commodity prices. Combined with fiscal tightening after Brazil's October elections, this will lead to a clear slowdown in 2023. Unexpectedly strong resilience in the face of sanctions has led to a sharp upward revision of our Russia forecast, with GDP now expected to fall by only 4 per cent this year. The world is too dependent on Russian energy to cut the country off completely from the global economy. But due to sanctions, the EU embargo and the sharply reduced activities of Western companies in Russia, the decline will continue in 2023. Shortages of Western technology and input goods will probably also lead to stagnation further ahead.

Complex relationship between Beijing and Moscow

The EU's decision to reduce its dependence on Russian energy has led to a redirection of oil and gas exports to other markets. Russian oil is discounted by USD 20-30/ barrel compared to Brent oil. China, India and Turkey have taken advantage of these lower prices and boosted their imports. Like Brazil and South Africa, they have not agreed to comply with EU and US sanctions against Russia. China's exports of manufactures such as semiconductors have surged during the Ukraine war. Beijing, which is becoming the Kremlin's most important trading partner by far, will not end its "friendship without borders" with Russia. But major Chinese firms will be cautious to avoid being hit by US-led sanctions. To Beijing, friendly relations with the Kremlin are useful given potentially more tense relations with the US. But relations with Russia are not especially important to China compared to the Taiwan issue or relations with the US and EU, which are far more crucial to China's economic well-being and domestic political stability.

Payment crises in smaller countries

Concerns about global recession, falling commodity prices and rising interest rates have led to major capital outflows from emerging economies, following the Fed's key interest rate hike in June. Larger, richer EM economies in Asia with government debt below 50 per cent and external debt below 70 per cent of GDP will fare relatively well, thanks to fiscal and monetary policy flexibility. But various economies with low GDP per capita such as Sri Lanka, Zambia and Ukraine have already defaulted on their debts. Some 40 other countries, including Pakistan and Egypt, are at risk of having to restructure their loans. Since these loans are relatively small, such problems are unlikely to lead to a global crisis. But rising interest rates and a slowdown in growth will have a dampening effect on stock, bond and foreign exchange markets in EM economies over the next 6-12 months.

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