SEB House View

9 March 2022

SEB

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The war and commodities changes the balance

Investment Regime: War and oil, the driving factors

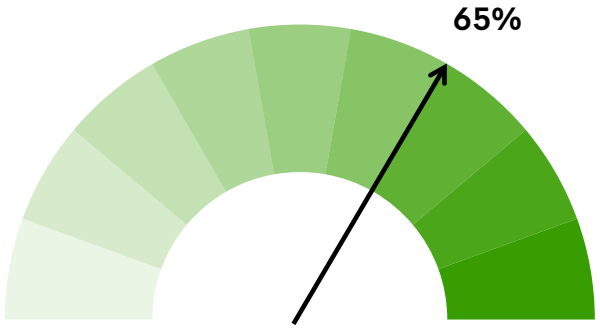
- Markets are heavily repriced as an effect of the current situation in Ukraine
  - The aggression from Russia has heavily affected the outlook and it is now important to understand and have a view on risk on the coming year
- The link between oil, commodities, inflation and growth is in focus and there is no doubt that a heavily higher oil price affects growth
- The darkest scenarios today brings us back to the oil crisis in the 70-ties.
  - That's not likely in our view as the global dependency of Russian oil is big but not total – Russia produces 11% of the worlds oil output and a considerable part of the natural gas output
- In the medium term there is a likelihood that the world can replace a reasonable part of the production
  - But natural gas is more troublesome as there are transport issues
- Market disruptions are always unwelcomed and there's no discussion
  - The risk of higher inflation is through commodities and that effects growth which is a challenge, but at the same time it is important see that both the US and China is in good shape and not close to recessions
- The post-covid period is here with strong demand and China will actively stimulate growth from Q2 this year

- **Risk utilization: We stay at 65%**
- One important reason to stay with a positive view on risk and markets is the fact that the general growth picture is benign
  - Even if there is an uncertainty on inflation and growth the backdrop is on the positive side and markets has substantially repriced the risk
- The general dependency on Russia/Ukraine from a growth standpoint is minimal
  - The stimulus from good growth in the US and stimulus in China and actions in Europe to increase capex far outweigh their presence
    - And with that is the fact that central banks will most likely be careful

Investment Regime

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

Speedometer



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

Investment Regime:
Growth will most likely persist; pricing the level is the challenge

The world will grow, but we will persist with higher oil prices

The dependency on oil is not at the same level as it was in the 70-ies. Oil is 3% of the American consumers expenditure. The coming moths we will hopefully see new supply lines to the commodity markets. The investment level has been low the last years and the higher prices is an incentive to ramp up. It's also important to remember that even as today's new world is challenging the world is entering the post covid period. Growth over trend was the forecast most research houses had penciled in for 2022. The question at this point is how challenged is that forecast. Simply put, an oil price of $200 can take 2-3% of global growth according to estimates. We are not close to that level, but if we get an oil effect on growth that might well be met by further fiscal stimulus in China and Europe which is also taking place now. The conclusion is that we will see growth going forward.

Central banks have a more challenging environment

There is no doubt that the oil situation challenges inflation forecasts. The question is how aggressively central banks will act. The FED will raise rates soon, but its likely that ECB will act with caution. In general, monetary policy will hold focus on maintaining growth without letting inflation loose and challenge growth. Today, wage growth in the US is 5.8% and seems to be peaking. This points towards the possibility of a slightly lower inflation rate post covid as bottlenecks may ease. And if the supply of oil picks up globally the risks will diminish in the second half of 2022.

Fiscal spending is on its way

The set up for fiscal spending has shifted. China will be stimulating to achieve their new growth target of 5.5% which was higher than consensus. In Europe we will see increased military and fiscal spending as the outlook has shifted considerably

Earnings will probably continue to be good for the coming quarters

As long as we continue to expect good growth the picture will be reasonably benign. The earnings season has also indicated that companies cope well with challenges in rising prices and bottlenecks. The dark horse in the discussion is if the inflation outlook will give an advantage to companies with pricing power or create margin issues.

Macro Good post Covid growth Q2 is a new starting point...	• 2022 GDP forecasts are positive, so far but will be adjusted on inflation issues • The inflation/growth balance is floating • Commodities and new supply issues will affect inflation
Central banks A decisive road to normality, with care	• FED tone has shifted to focus on inflation • Faster tapering and rate hikes on the horizon, but probably on a careful path • Yields will move upwards from here
Politics A new situation. China support will rise	• We are getting a new set of fiscal measures to meet the Russia/Ukraine situation • The Chinese government will likely support the economy with more stimulus
Corporates Managing risks; earnings forecasts are so far good	• Earnings will likely stay strong, but price pressures is still a risk • As yields may now rise we monitor multiple expansions • Inflationary pressures from commodities is a risk factor

RISKS Persistent inflation | Ukraine war | FED policy mistake | Weaker macro

Asset Allocation

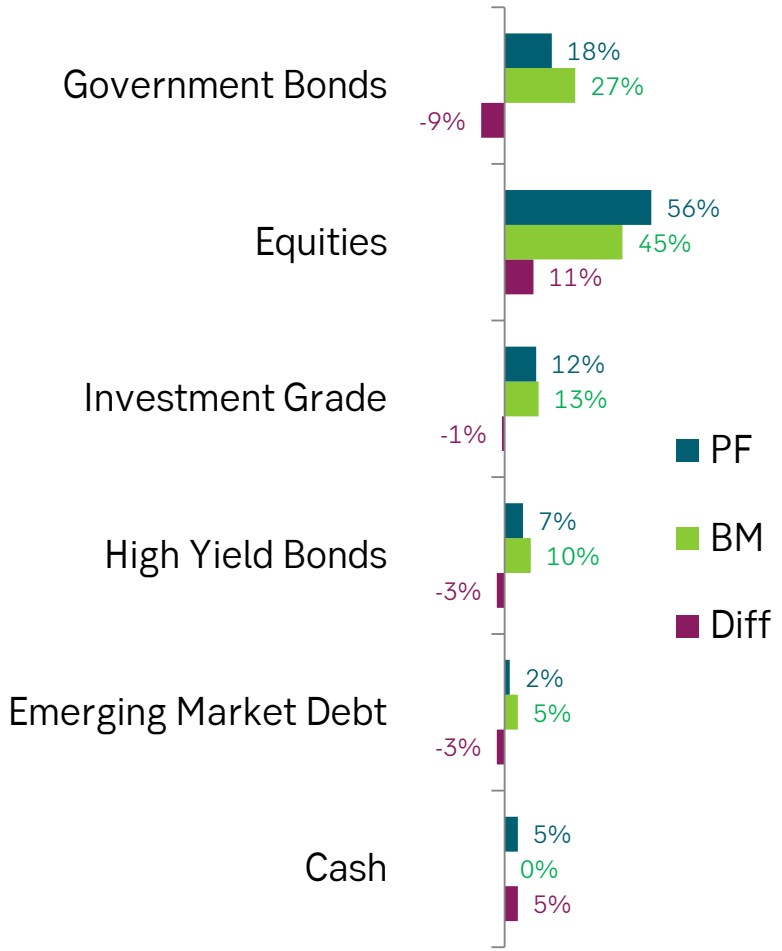
A challenging world.... but growth is what finally decides

- The asset allocation discussion today has a set of parameters that guides the strategy
  - The first is that a stagflation scenario is not likely. Growth is rather stable and the effects of higher oil prices is not enough to close the business cycle
  - The second being that the inflation level is most likely higher than expected before the onset of the Ukraine/Russia conflict
    - With those assumptions the question is how to invest in equites – as bonds will most likely not fare well in that environment.
- Equities is the asset class that can function in an inflationary world as long as we are below double-digit inflation
  - Markets may face challenges from rising input costs, but the volume component is probably more important, unless we get a real demand shift
- But its important to consider how to invest as parts of the equity market that will likely perform the best are those that can raise prices in this environment
  - A degree of cyclicality is important. Value stocks often have their moment of glory in these periods – short-lived but successful
    - 2022 might be the year when the value growth spread shrinks
- Bond markets have been relatively stable during the last phase largely as a reaction of investors de risking their portfolios
  - If we get a clearer scenario on the war and the level of sanctions this trend will most likely turn otherwise the negative real yield will be extreme

We adjusted our allocation at our last update and prefer now to stay

- Markets are heavily sold after last week and its understandable as many of the parameters are unstable. That probably means that some assets are now oversold
  - Most indicators of risk-taking screams buy as does our Risk Indicator
- This is a hard time to fine-tune and therefore we focus on the high-level discussion
  - Equities will likely fare better than bonds
- Spreads in the corporate bond market has risen but the level is still not attractive
- Emerging Market Debt is interesting but with the current USD trend its also too early.
  - But when the trend stabilizes these are well positioned

Model Portfolio



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

Regional equity allocation

Investing in the volatile phase…

- We prefer to keep our strategy directed towards regions less affected by what happens in Ukraine – and in some sense acts as a haven
- US is often a risk-off asset leading to stronger USD and in general a flight to safety
- The US exposure to Russia is minimal
  - They have their own natural gas production and a potential to replace imported oil
- The business cycle is in the post-covid phase shows strong indicators on growth from PMIs and consumption
  - The latest consumption indicators pointed to a need to lift GDP forecasts.
- We therefore overweight US in the portfolios

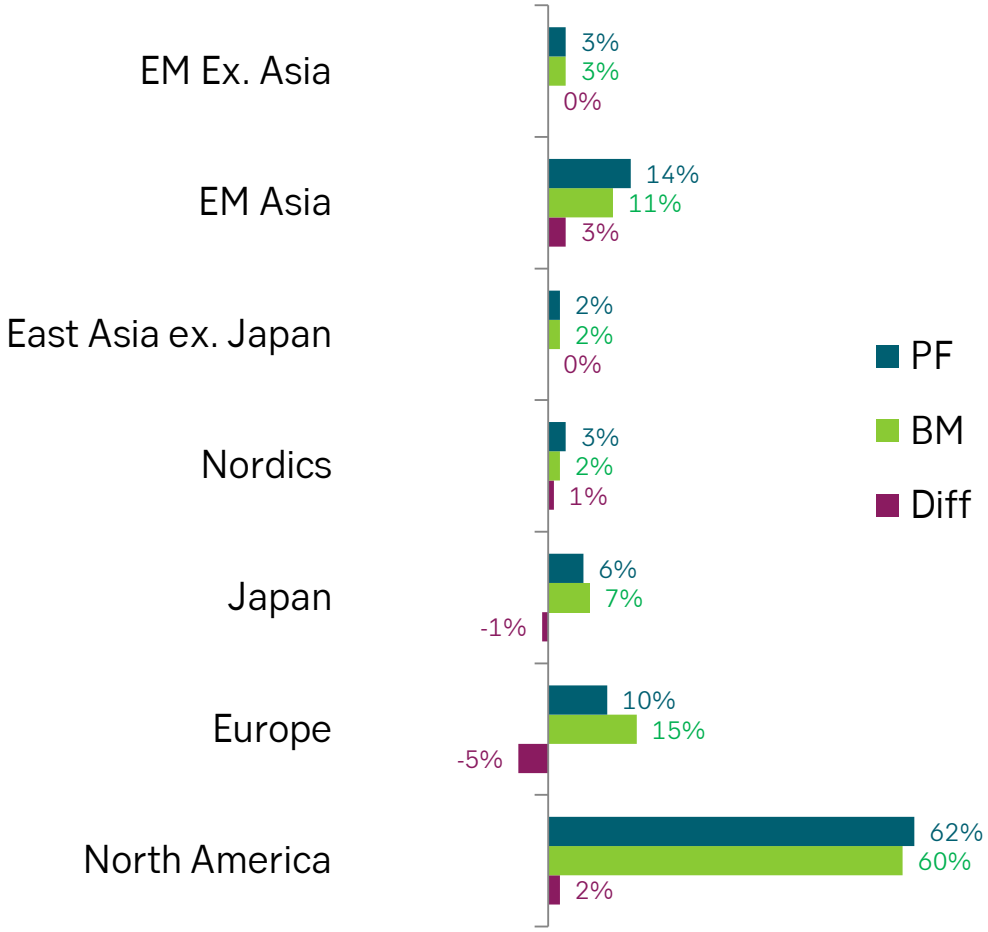
The Nordics and Europe are in a tricky position.

- Europe is the region most affected by the war in Ukraine
  - The dependency of oil and natural gas is relatively big and therefore the sensitivity to sanctions is a challenge. There is also a more marked trade dependency
- In the long run the industry composition of Europe is possibly quite good in an environment with higher inflation
  - Europe is more of a value region than the US, but given the current risk-off phase, its probably too early to enter that position

Asia and China are attractive and further regions in EM are under consideration

- We hold an overweight in EM Asia and that is motivated by the stable positions and small dependency on Russia
  - The Chinese strategy when it comes to growth is positive as there is an ambition to increase growth and lift GDP growth to 5.5% in 2022
    - Through fiscal stimulus and increased investments in infrastructure
- EM ex Asia is to a large extent commodity producers in South America
  - They are in an interesting position, but a strong USD and ESG considerations makes the region not attractive enough

Regional equity positioning



Benchmark is MSCI All Country

Sector allocation

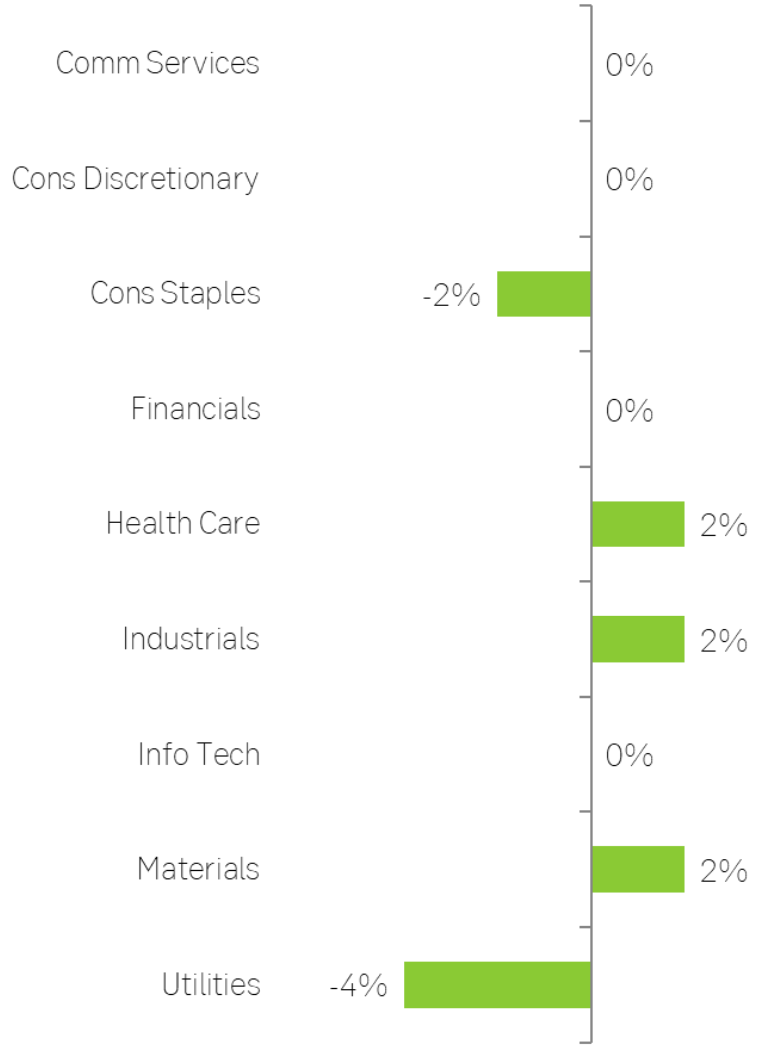
The situation indicates that the risk for inflation is higher

- We need to adjust the portfolio to a potentially higher inflation level
- The first asset to reduce is Financials which we take down to neutral and instead we add a position in materials
- Financials can be affected by the situation in Russia due to heavy sanctions
  - There is a heightened risk of credit issues even if exposures as we see them today are low
- Materials can benefit from higher demand and prices
  - The sector has low control over prices but the sanctions on Russia can create some opportunities
  - Another reason to look at materials is due to its flexible price history which always reflects the inflation level. Most inflation stems either from commodities or labor
- Industrials are in a good position; traditional industry is often in a position to lift prices and respond to new volumes
  - There is a likelihood that we will see more capex in the commodity space that will create demand for industrials

Our strategy reflects or view that growth will still be an important fact

- The direction of bond yields will be upwards as soon as the situation in Ukraine becomes more stable
- Higher inflation will persist for a while leading us to have a negative outlook for bond proxy sectors
  - Utilities and Consumer Staples correlate with bonds and will find it hard to perform in an inflationary environment
  - They are also low growth sectors which makes them less interesting in the long run
- Consumer Discretionary and Communications services are good long-term sectors and in a more stable inflation environment these are natural overweights, so it is not time to overweight yet
  - Bond yields have to stabilize on a new level first

Sector positioning



Risks to the investment regime

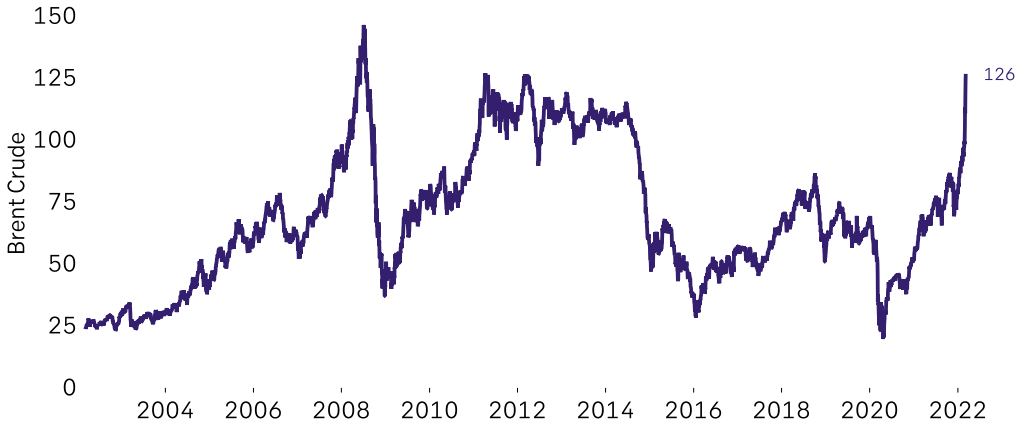
Higher commodity prices threaten the growth outlook

- The most complicating matter now is what effects will we see in inflation and growth from continuously higher commodity prices?
  - There is no clear answer to this, but markets will react negatively
- Estimates add up to a loss of GDP globally of 3% if oil hits $200
  - That acts through inflation, less consumption and reallocations of capital to oil producers
  - A small good thing in this problem is that Biden has asked his teams to design sanctions so they won't hit American consumers
  - Parts of Europe is also negative to sanctions on oil and Natural Gas, but ultimately the producers has a choice

Will central banks get behind the curve?

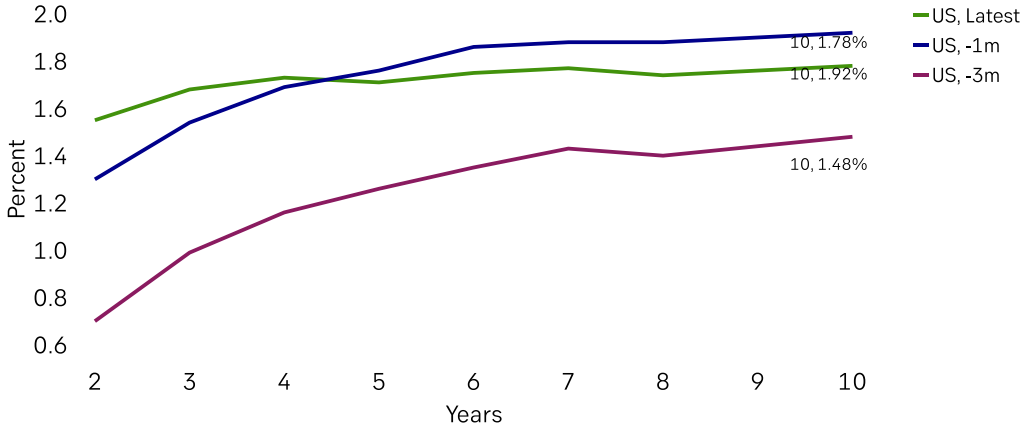
- There is a risk thar central banks will try to keep interest rates low for longer and to support consumption if higher commodity prices affect consumers
- Potentially this can lead to pent-up inflationary pressures which becomes built into expectations and may affect consumption
  - That would later lead to aggressive 80-ies style monetary policy and a following recession

Figure 1: Brent crude has spiked due to the recent escalations in the Ukraine/Russia situation



Source: Macrobond, SEB

Figure 2: The yield curve has flattened quite quickly signaling that the bond market is more worried about the outlook



Source: Macrobond, SEB

Return Estimates

Figure 1: 12 month forward looking return expectations

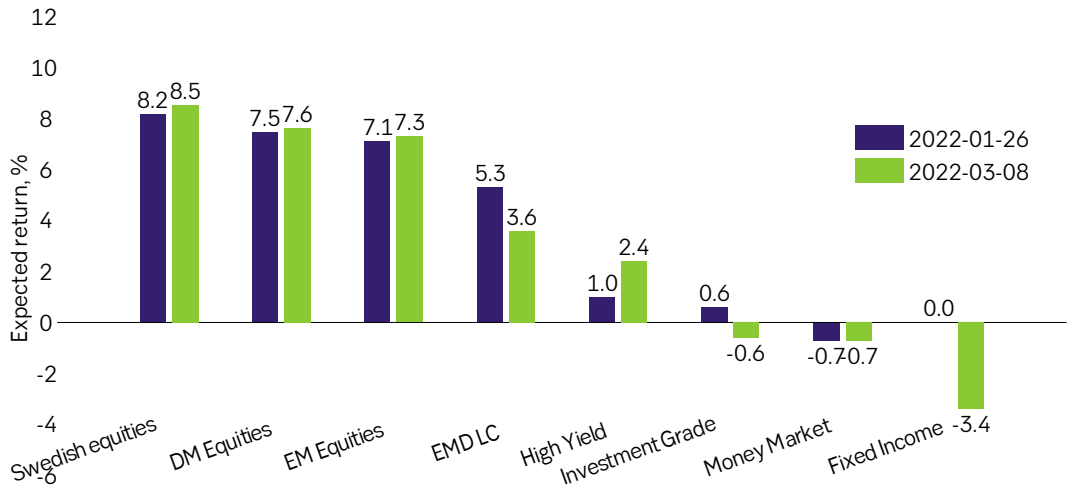


Figure 2: 12 month forward looking return expectations for equities and bonds

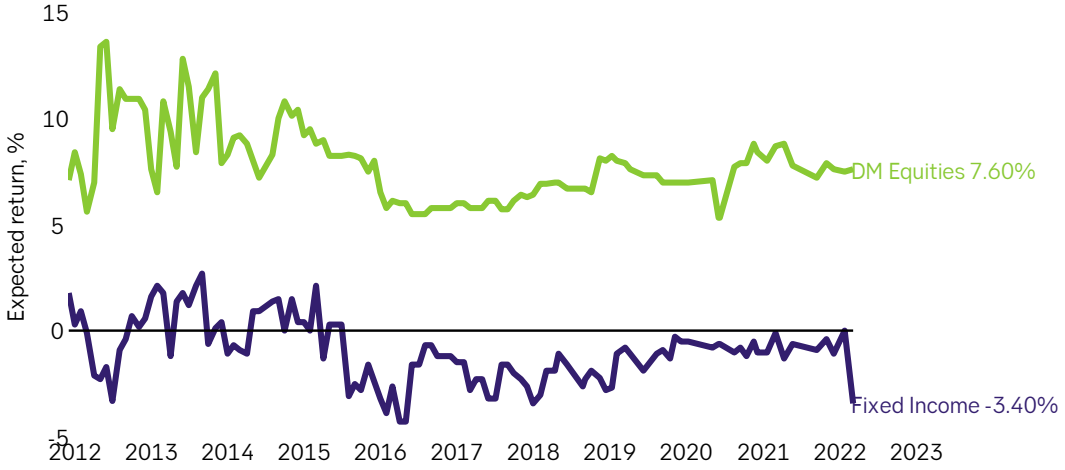


Figure 3: Absolute expected returns

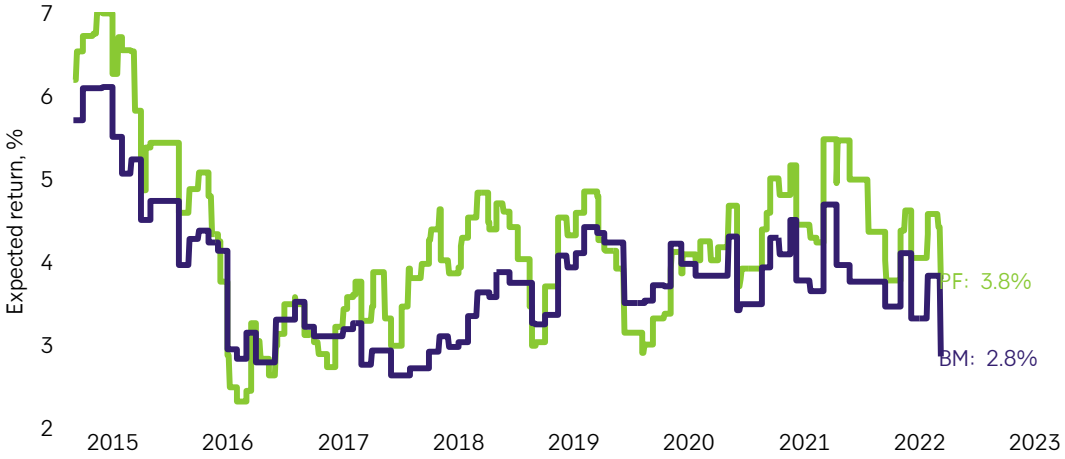
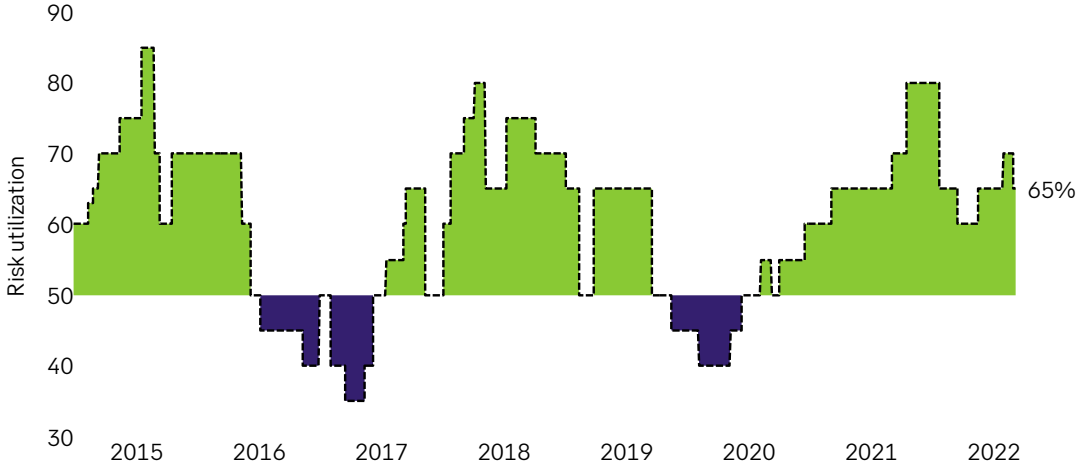


Figure 4: Risk utilization since inception



Historical House View Allocation

Figure 1: Equities

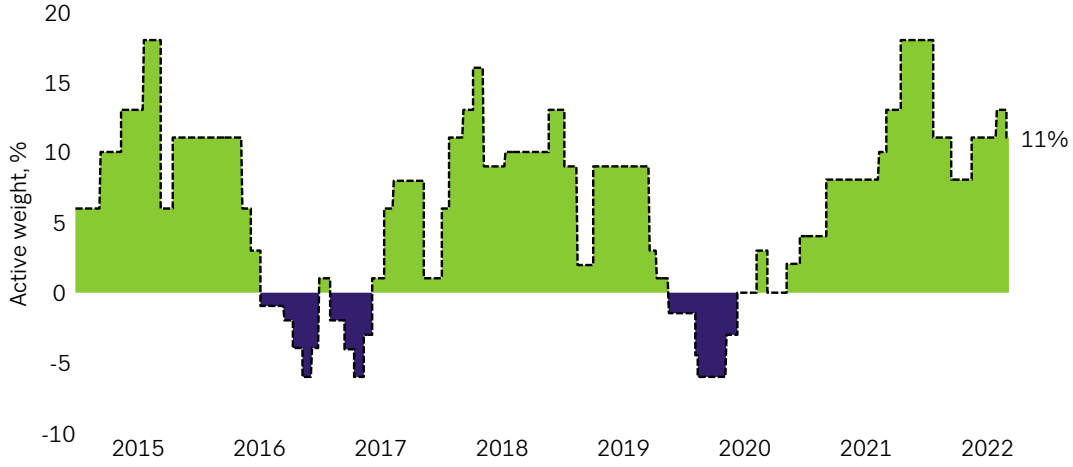


Figure 2: High Yield

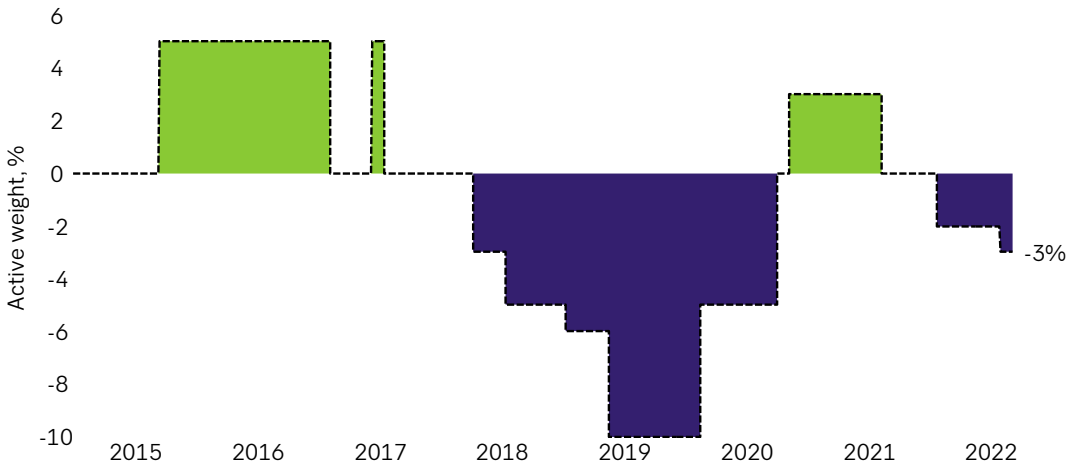


Figure 3: Emerging Market Debt

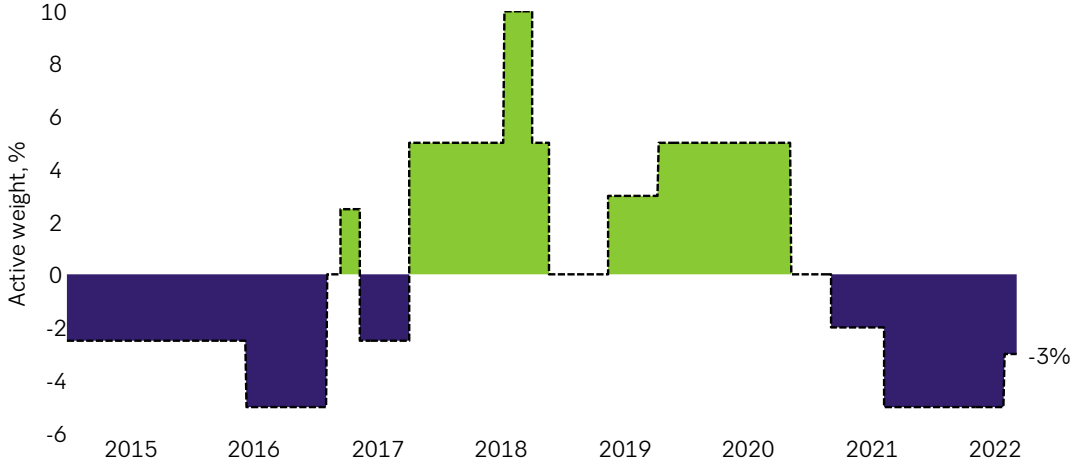
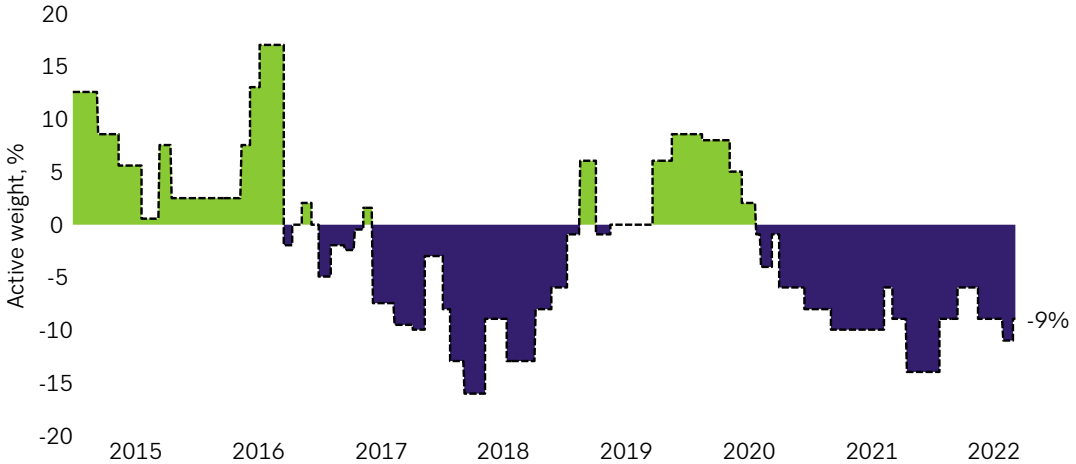


Figure 4: Fixed Income*



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

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House View decision variables

The war in Ukraine has driven the market as of lately and is an important variable in our risk taking

- Uncertainty has increased in the markets as investors attempt to assess the impact the war in Ukraine and corresponding sanctions on Russia will have on the market
  - The situation is very fluid and difficult to asses, but we think that a longer duration of the conflict could have further negative long-term implications for the outlook

Recent macro data is pre-war in Ukraine and paints a robust macro picture, but the outlook is now cloudier even if we expect the economy to remain on its recovery path

- Before the breakout of the war in Ukraine we were entering the post-covid period with strong demand and decent growth outlooks
  - Various fundamental parameters were already expected to shift this year, and the new situation has intensified the uncertainty surrounding the growth outlook as the link between higher oil prices and commodities affects growth

Central Banks actions remain important as they face a difficult balance in controlling inflation whilst also supporting the economy

- The Russia/Ukraine crisis has likely delayed the ECB's hiking plans
- While the Fed will likely go ahead with its hiking path as the economy maintains robust growth momentum and the prospects of higher-for-longer inflation

Fiscal policy has increased in importance and valuations are now more positive

- China is stimulating and western governments will likely add stimulus to usher the cost of higher energy prices
- Valuations have come down and are now more positive in our view

On a 3-6M horizon the House View Committee holds a positive view on risky assets and we prefer to remain slightly overweight to equities

- In our view, the biggest risks for equities in the next months is further deterioration in the Ukraine/Russia conflict

Figure 1: Politics is a very important variable in our risk taking given the war in Ukraine. With that comes Central Banks which are facing a tricky situation

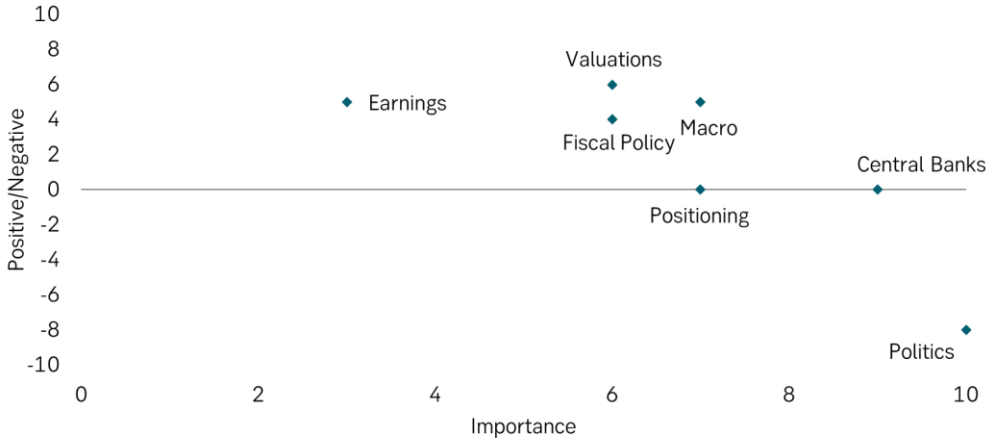
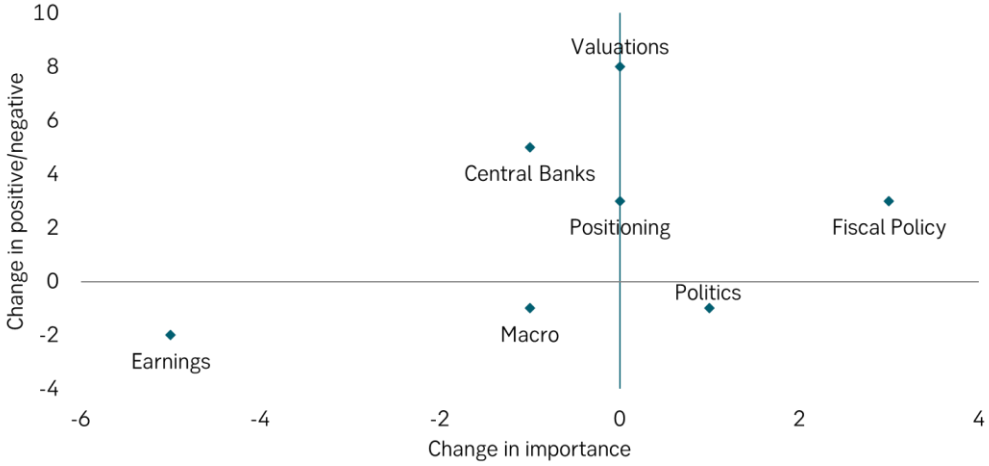


Figure 2: Politics and fiscal policy has increased in importance. Valuations have come down considerably and are now more positive for equities than last month



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Developments in the Markets

Global markets fell sharply due to the Russian invasion of Ukraine

Global equity markets fell on the Russian invasion of Ukraine as increased market fears and uncertainty over geopolitical risks led to a sell-off in risky assets. Economic sanctions on Russia from the West led to strong declines in Russian equities and the Ruble plunging more than 30% during in one day. European equities saw also large declines as the market has closer ties to Russia. The negative news concerning the war in Ukraine and the economic sanctions led to commodity prices increasing broadly, with oil prices going over $100 a barrel. The war in Ukraine and related sanctions propelled the VIX index to move passed 30 as the uncertainty increased surrounding the market outlook for the economy and implications on the inflation outlook. The risk-off sentiment in the market strengthened safe-haven assets like bonds, gold and the dollar. Equities had already seen a downturn in markets prior to the breakout of the war in Ukraine, but the recent escalation triggered further declines. That is, the outlook of a tighter monetary policy and rising bond yields had been the main driver and downturn of the market until the Ukraine/Russia war broke out which intensified the fears of the market.

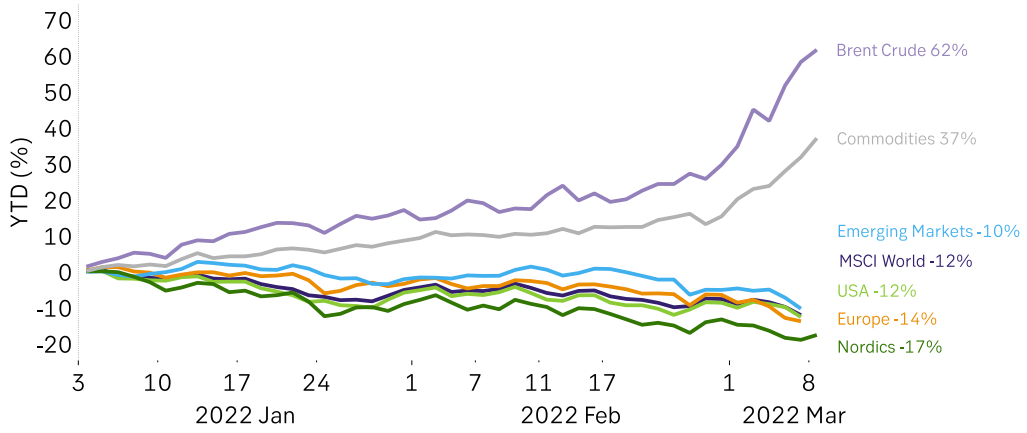
The Fed meeting minutes from January confirmed a tightening of monetary policy

The Fed meeting minutes from January stated that the central bank will start to reduce its balance sheet later this year once it has begun to increase rates. The minutes did not reveal anything about the size of the anticipated rate hike in March. Markets are currently pricing in a 25 bps hike in March, down from 50 bps earlier in February, because of a less certain outlook due to the situation in Ukraine.

US Treasury yields fell after Russia's invasion of Ukraine

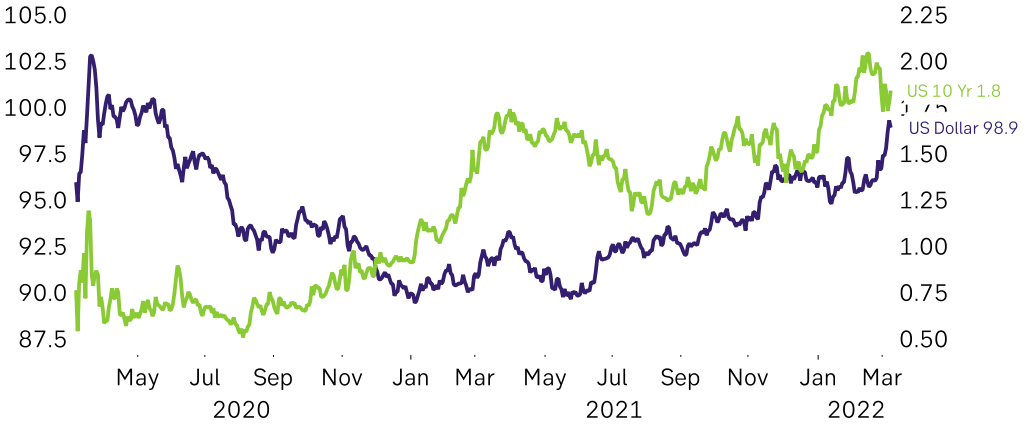
The war in Ukraine caused investors to sell risky assets and buy the US 10Y Treasury which led to a higher price and lower yield for the benchmark. The US yield curve has as of today flattened since the invasion. Long-term yields moved very quickly upwards at the start of February due to expectations of a tighter monetary policy, but the breakout of war in Ukraine made bond markets more wary of the outlook

Figure 1: Global equities fell sharply in late February due to Russia's invasion of Ukraine. We saw strong gains in commodities and oil as sanctions were announced



Source: Macrobond, SEB

Figure 2: Investors moved towards safe-haven assets after Russia invaded Ukraine. US treasury yields fell and the US dollar rallied strongly



Source: Macrobond, SEB

Economy – Developed Markets

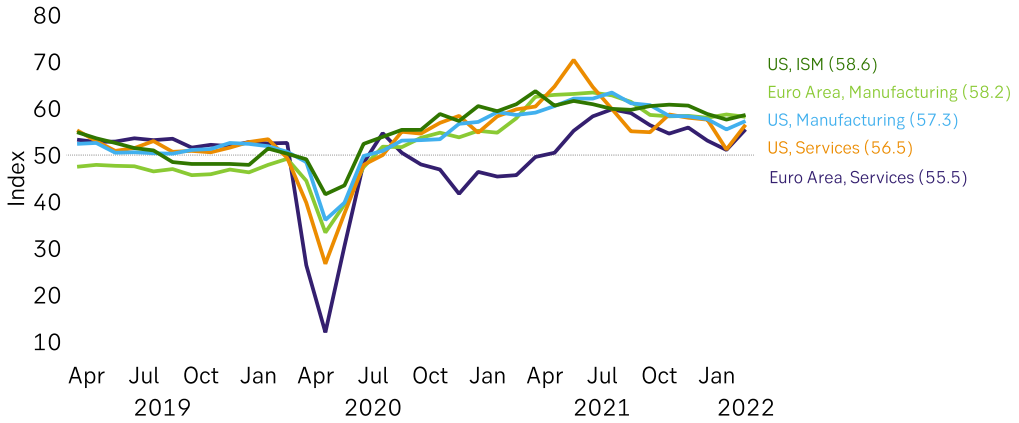
Despite the escalation in Ukraine, macro data has remained resilient in the US

- US manufacturing activity regained momentum after the omicron setback last month
  - The sector remains in a demand-driven environment with strong new orders, export orders, backlogs and low customer inventories
  - The supply-side showed that constraints remained, but the invasion of Ukraine from Russia is a growing risk to global supply chains and prices
- The service sector showed a discrepancy between ISM and Markits Services PMI
  - The ISM Services gauge plunged due to enduring coronavirus restrictions
    - But given the current easing of restrictions, we expect the indicator to bounce back next month and converge with Markits upbeat indicator
- Employment data surprised to the upside in February and we got upward revisions to January, signaling a strong job market
  - Labor force participation improved and the unemployment rate dropped further
  - Moreover, a weak wage growth signals indicated no wage inflation
  - We have a very tight labor market and will likely see a first rate hike in March
- The main concern is inflation which remained high in the January figures and has dented real income growth into negative territory
  - That is, although nominal income is higher, real disposable income is lower
    - And this could erode consumer spending moving forward

Aggregate macro indicators in Europe improved in February

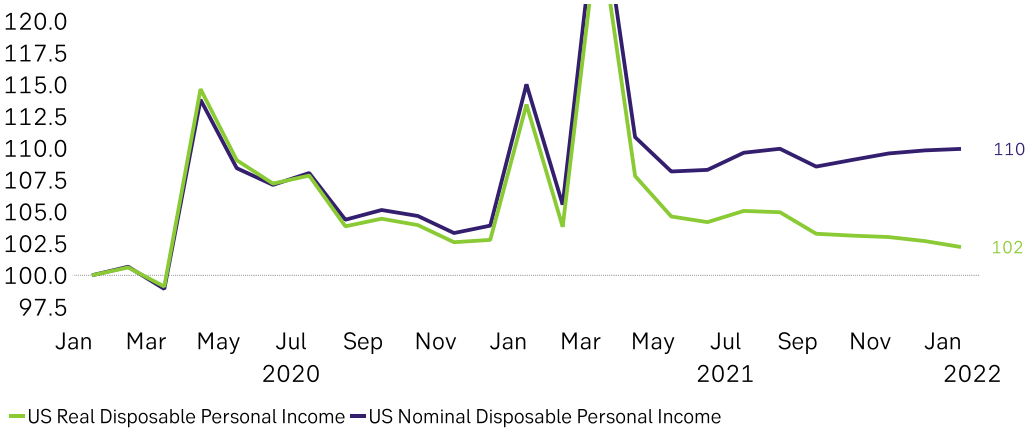
- Macro data improved in February as the worst of the omicron wave passed and consumer services recovered more fully
- But inflation data in February soared to 5.8% as energy prices continued to climb
  - The war in Ukraine is driving the cost of commodities higher, which will likely add to inflationary pressures in the month to come
- The minutes from the ECB signaled that the bank was planning to lay out a plan for normalizing monetary policy as the risks of elevated inflation for longer were rising
  - But with the breakout of war in Ukraine, the ECB may be forced to delay its decisions

Figure 1: Services rebounded in February as economies reopened. Macro indicators are still at strong expansionary levels



Source: Macrobond, SEB

Figure 2: Inflation has reduced Americans personal income, as inflation-adjuster, after-tax income, or real disposable personal income, is now closer to its level at the start of 2020



Source: Macrobond, SEB

Economy – Emerging Markets

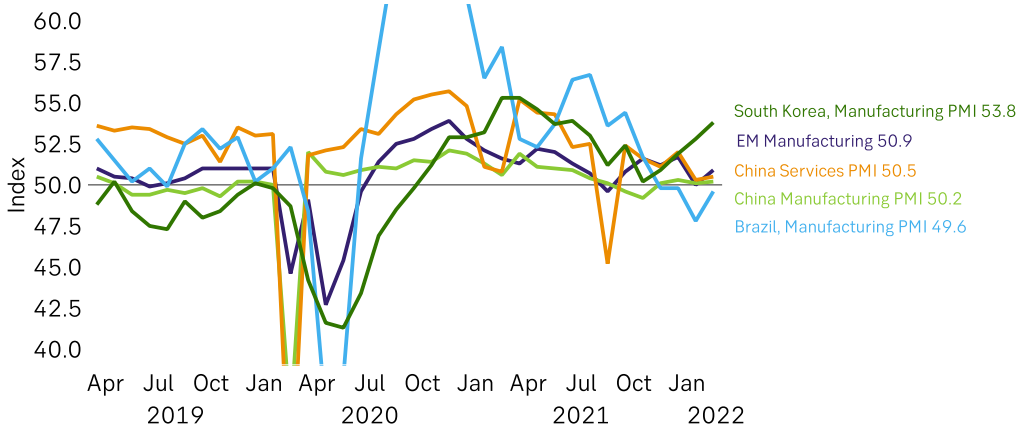
Leading indicators remain resilient despite sustained supply chain disruptions

- Strong external demand for Asia's products boosted macro data in the region
- However, Asia is still facing challenges with logistical problems as supply chain bottlenecks continued to delay supplier shipments
  - And production costs continued to climb in February
- Latin America macro has surprised to the upside lately with improvements in its domestic demand which has benefitted from lifted mobility restrictions
  - Moreover, with the likelihood of a commodity boom extended due to the sanctions on Russia, this could help buoy the assets of commodity rich countries
- Central banks in the region will probably push towards a hiking path, with the exception for China which is moving towards easing its monetary policy

Chinese policy support appears to be boosting economic data

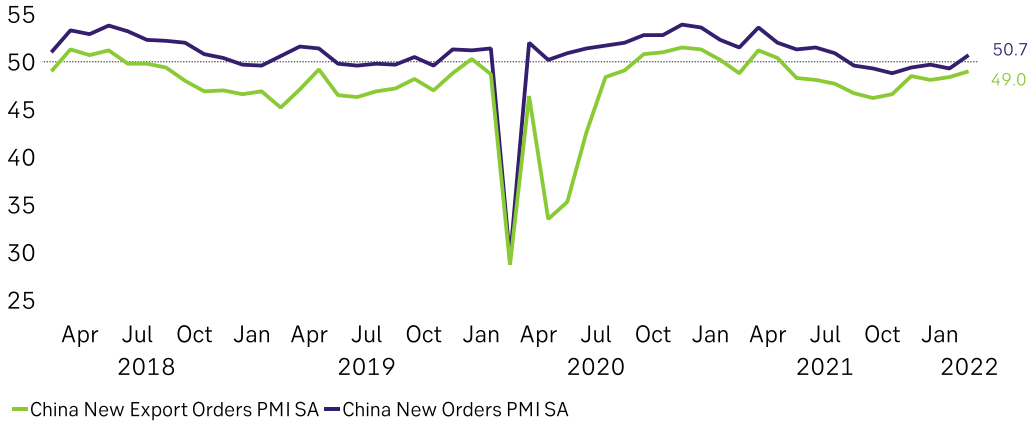
- China has recently signaled more policy support as it set an aggressive economic growth target
- At the National People's Congress the premier Li Keqiang vowed to step up monetary policy implementation and signaled more rate cuts
  - Apart from cuts in the lending facility rate, we may also see cuts in the RRR
  - Fiscal spending will increase by boosting investments in infrastructure projects
  - China will also set up a financial stability fund and market-based ways will be used to keep housing prices stable and so prevent systemic risks
    - This is to stem financial risks from its slumping real estate market which affected markets last year
- Fiscal policy will likely play a more prominent role in supporting growth through aiding small industrial and services companies by public investments and tax breaks to cope with soaring costs
- Moreover, considering the war in Ukraine, China has now a much stronger capacity to respond to external shocks than in previous shocks
- In February Chinese data continued to show strong demand as new orders and export orders further improved from last month

Figure 1: EM indicators for manufacturing has held steadily. But production costs and supply chain disruptions can still pose risks in the region



Source: Macrobond, SEB

Figure 2: Chinese data continued to show strong demand as new orders and export orders further improved from last month



Source: Macrobond, SEB

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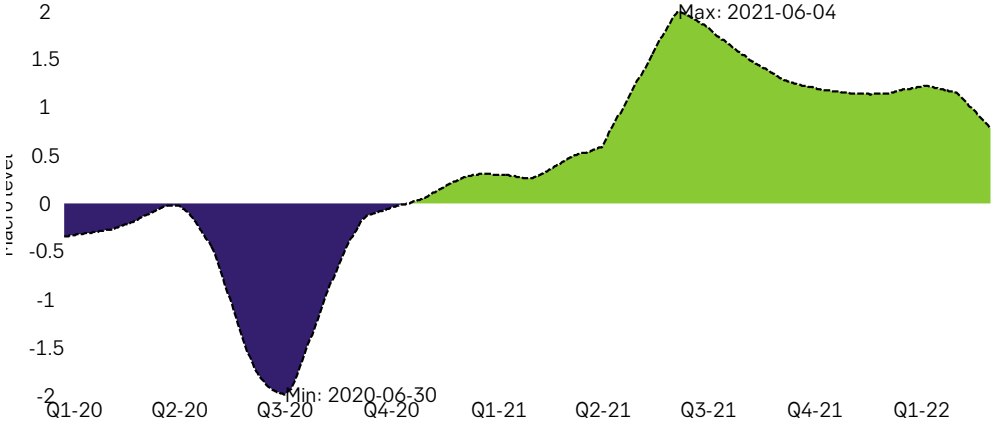
SEB House View – US Macro Status

US macro is still far above its 5y mean despite some negative momentum

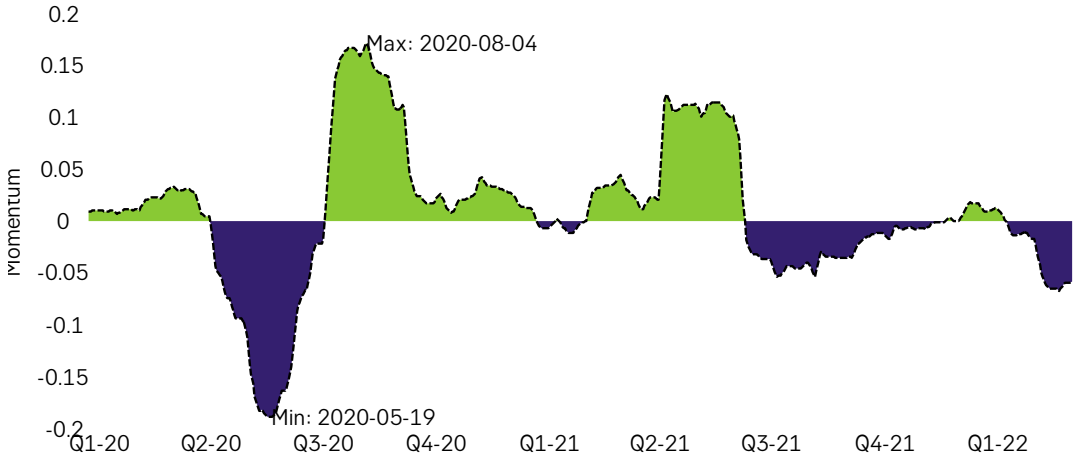
- Our surprise indicator moved to the downside in February as the latest Non-Manufacturing ISM for February came in below consensus
  - However, with covid subsiding demand for services could start to increase soon
- Personal disposable income subdued as well as we see an end of boosted government social spending which has also lowered consumers savings
- ISM manufacturing surprised to the upside due to strong demand on the back of new orders, backlogs and customers' inventories
- On the bright side, the US labor market is strong and will likely improve
  - Payrolls for February increased from last month and surprised to the upside
    - The US economy added 678k new jobs vs. 423k new jobs expected
    - Both the participation and unemployment rate improved and beat consensus
- Inflation is the main concern, with January figures surprising to the upside on headline figures

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



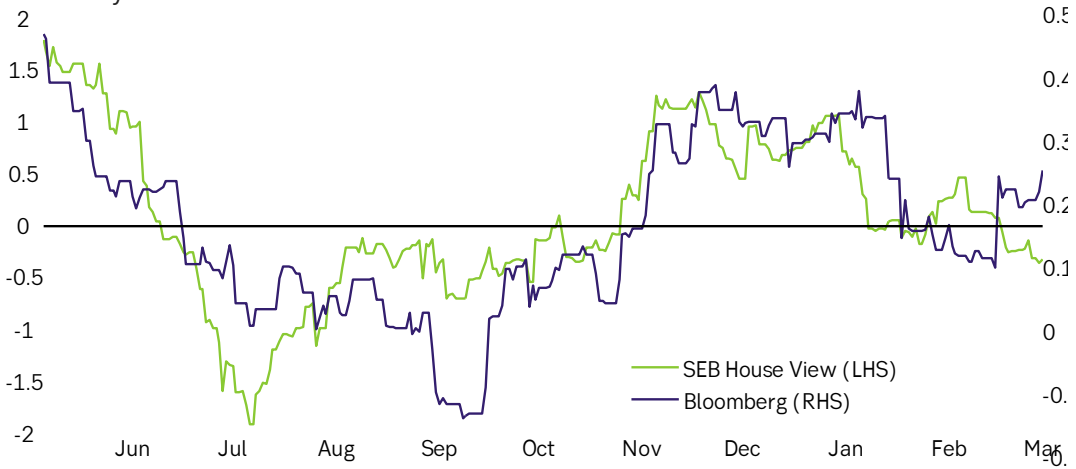
Source: SEB House View

Figure 2: Momentum weakened due to services and income – we expect a turnaround



Source: SEB House View

Figure 3: Our surprise indicator has been more negative than Bloomberg's surprise indicator in February



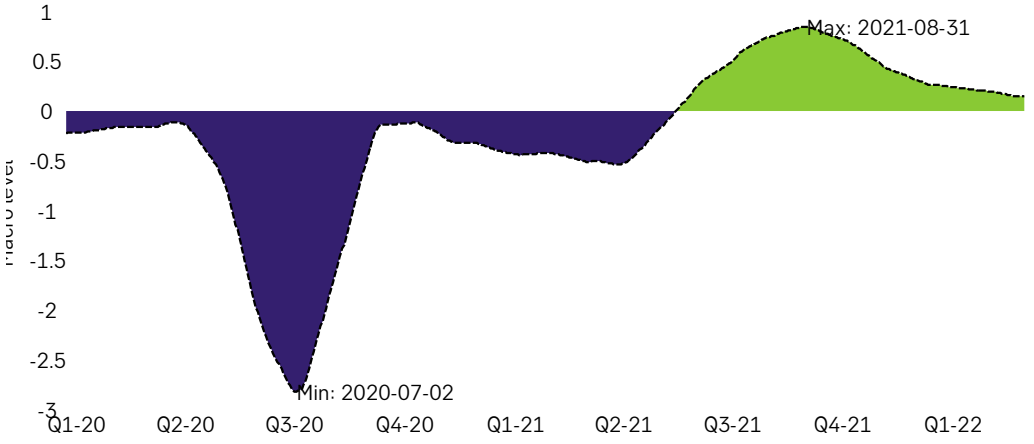
Source: SEB House View

SEB House View – EU Macro Status

EU inflation remained high and growth outlook uncertain amid geopolitical tensions

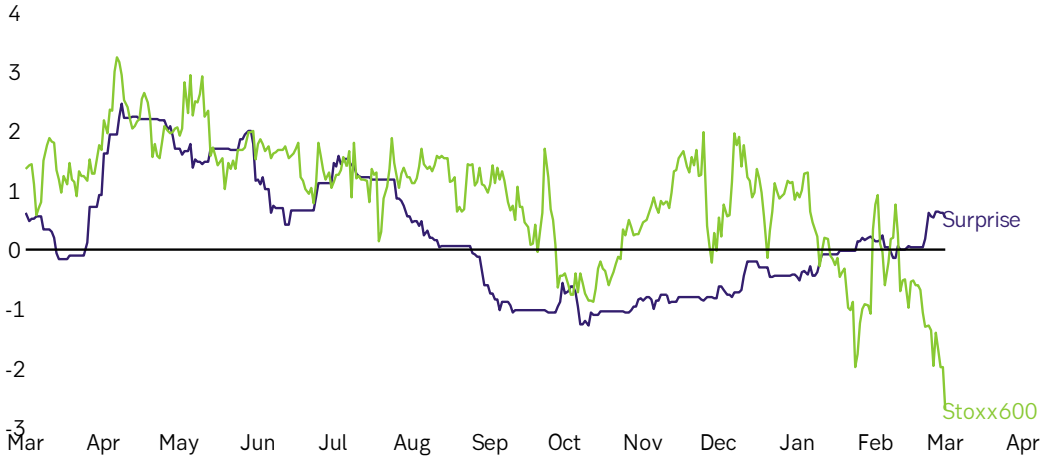
- Germany's IFO survey added to the positive surprises in European macro
  - However, we note that the figure was published before the breakout of war in Ukraine and may turnaround next month
- Euro area headline and core inflation for February surprised to the upside
  - Energy and food prices were the biggest pressures behind the inflation figures
    - The war in Ukraine will likely put further pressure on the price of commodities which will likely keep inflation elevated for the next months
    - Inflation in Europe is mostly driven by energy prices rather than strong demand
- Given the uncertainty for economic outlook in Europe, investors will focus on the ECB's meeting on Thursday and lookout for new growth forecasts and guidance on when the ECB will end its asset purchases program
  - ECB cannot affect energy supply, and thus cannot directly affect energy prices
    - Markets are currently pricing in the first rate hike by ECB in H2

Figure 1: European macro level remains positive, but risks to the downside are rising



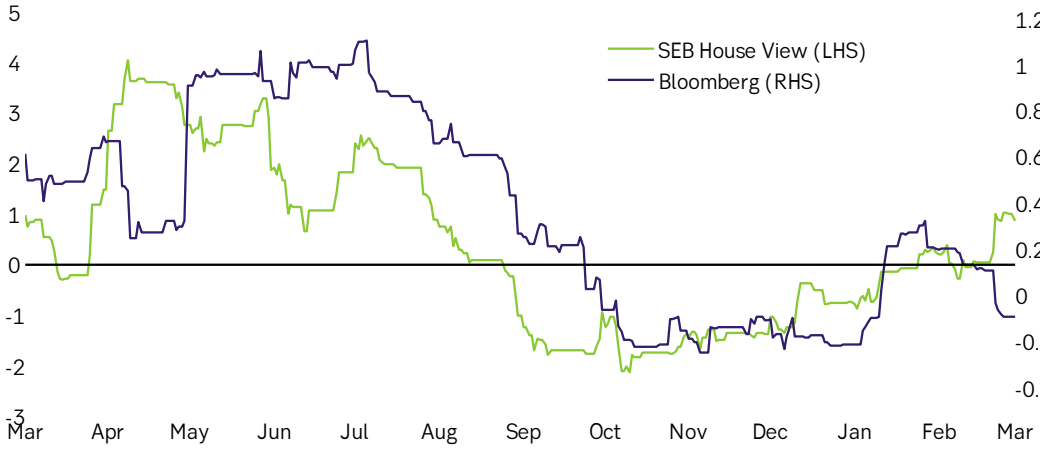
Source: SEB House View

Figure 2: Despite positive surprises, the STOXX600 moved solely on geopolitics



Source: SEB House View

Figure 3: Our surprise indicator is now more positive than Bloomberg's indicator in February



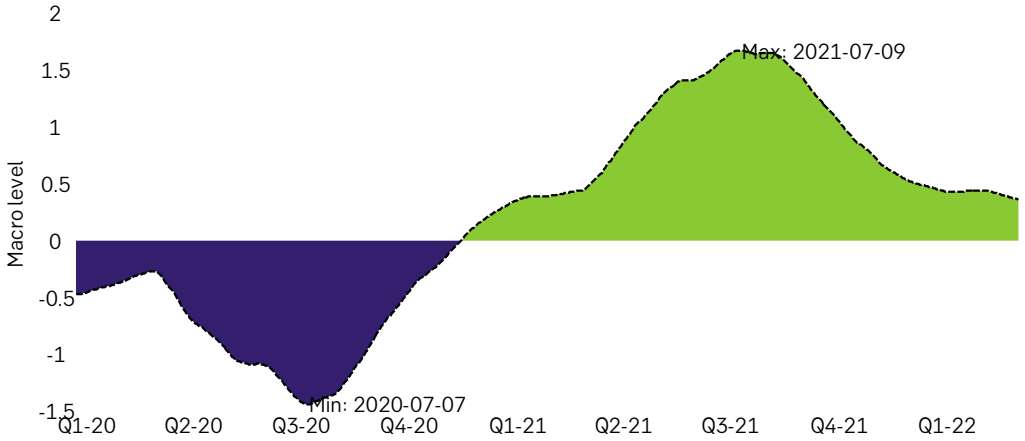
Source: SEB House View

SEB House View – EM Macro Status

Emerging Markets macro level remains positive and is likely more insulated from the geopolitical risks from Ukraine/Russia

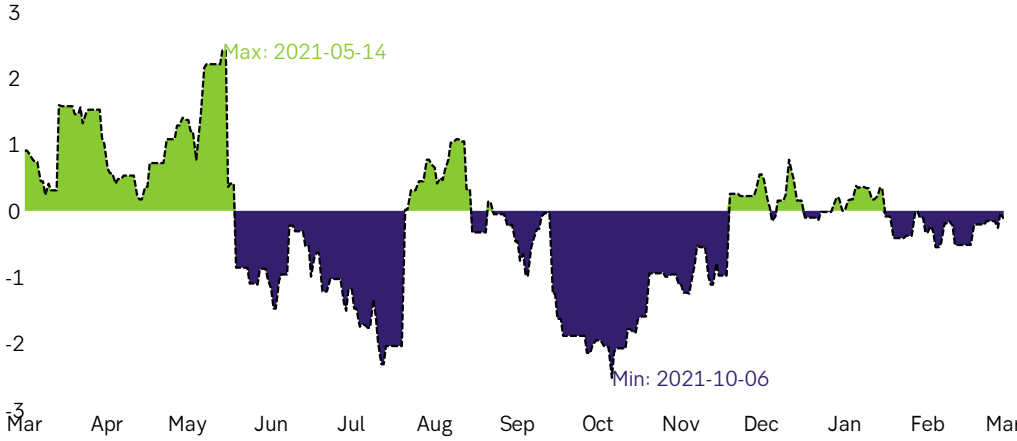
- HK exports, South Korean imports and Brazil retail sales contributed to positive surprises for EM macro data in January
- Official PMI:s in China surprised to the upside in February
  - PMI:s for manufacturing as well as exports came in above consensus, suggesting that the policy support is now kicking in
  - Services PMI also surprised to the upside albeit not as strongly as the manufacturing sector due to sustained regional virus flare-ups
- At China's latest NPC meeting, the government signaled further policy support by setting an aggressive annual growth target to 5.5 % for 2022
  - China will increase fiscal stimulus by increasing infrastructure investment and loosening controls on the housing market
  - And China's monetary policy will likely step up implementation through more rate cuts

Figure 1: EM macro level remained positive despite rising yields



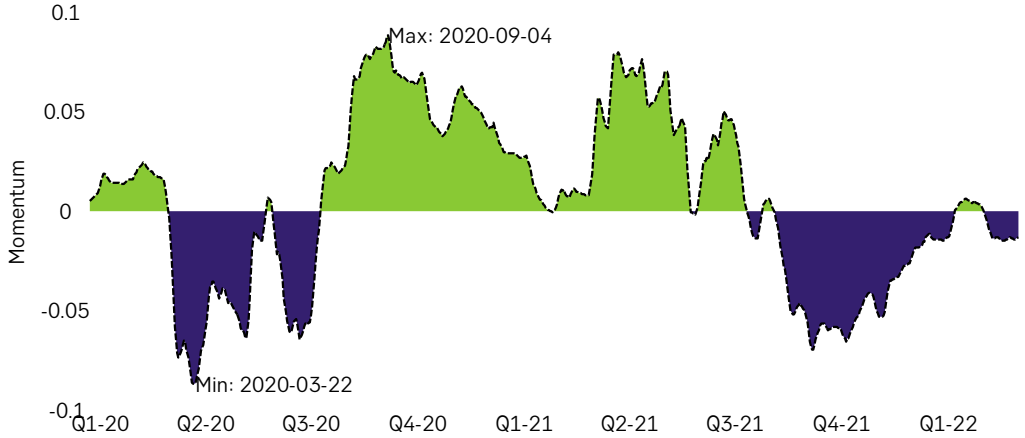
Source: SEB House View

Figure 2: Negative macro surprises in EM appear to be fading, slowly



Source: SEB House View

Figure 3: Macro momentum is naturally fading in EM as we enter a period of normalization after extraordinary export figures in



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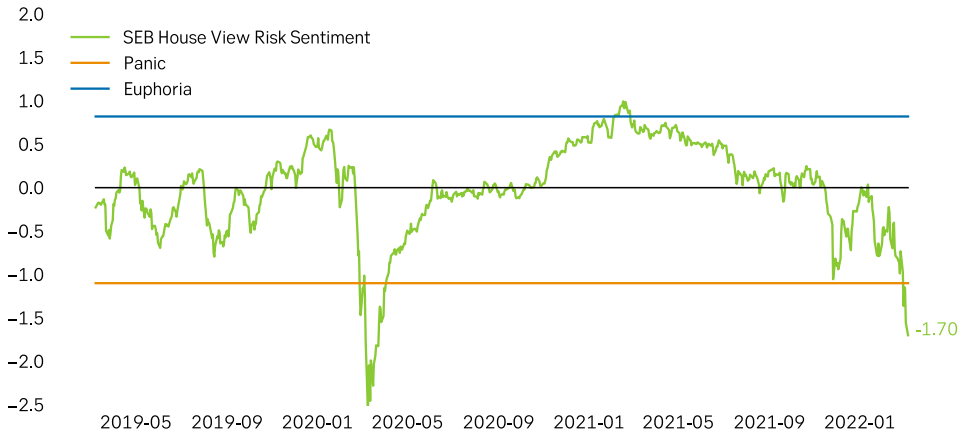
SEB House View – Risk Indicator

The Risk Indicator is now in Panic territory, signaling oversold markets and that it's time to buy due to the sell-off driven by the Ukraine/Russia conflict

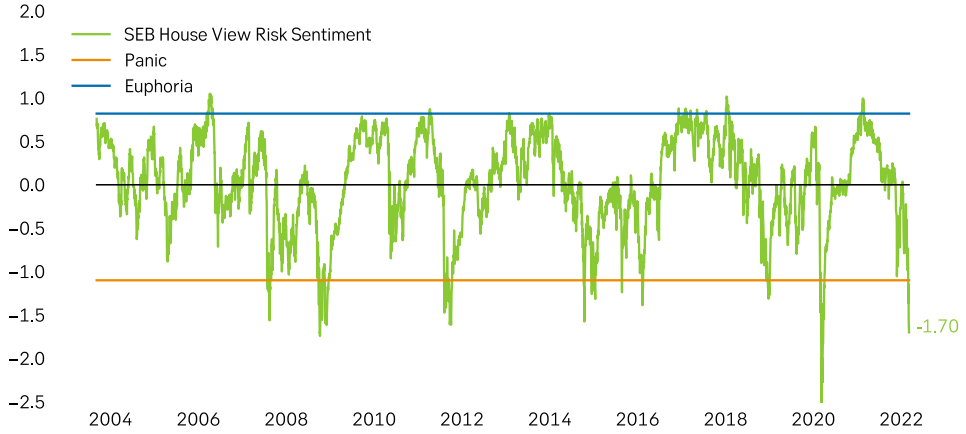
- Volatility in FX, European equities and Bonds contributed most to the current panic state
  - Credits, in terms of wider credit spreads has also contributed to the downturn in our Risk Indicator
- The indicator is more accurate when it comes to signaling market lows
  - Markets are pricing in an equity risk premium on the back of Ukraine/Russa conflict, which has de-rated stock valuations
    - From a historical perspective they look very cheap
  - But the current situation is very fluid and can change quickly

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



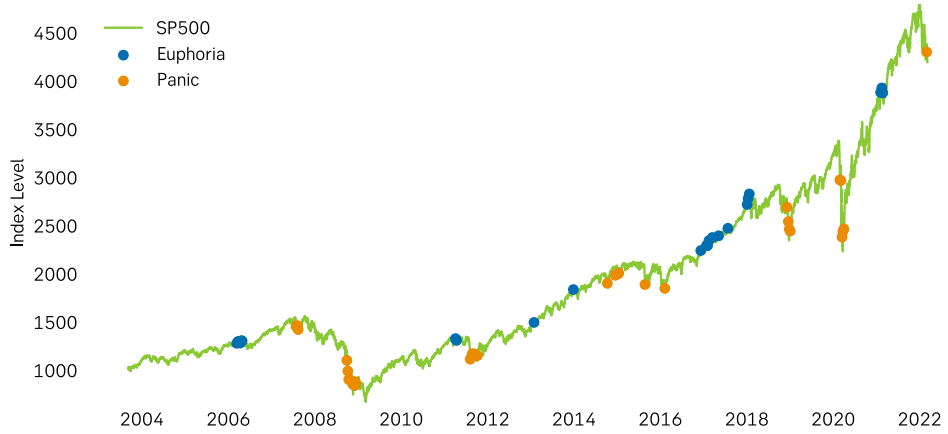
Source: SEB House View

Figure 1: SEB House View Risk Indicator



Source: SEB House View

Figure 3: Extreme states plotted on SP500



Source: SEB House View

In Focus: Invasion of Ukraine

As the Ukraine-Russia war continues, the risk is that energy prices stay elevated

- Russia's decision to invade Ukraine caught markets off-guard and immediately sent energy prices higher, including oil prices which recently hit eight-year highs at over $100 a barrel
- In order to fight the higher oil prices, the IEA recently announced that it will release 60 million barrels of oil from its strategic reserves
  - Meanwhile, OPEC+ has plans to increase their production modestly
- Although Western sanctions have not yet targeted Russia's energy sector, the option is still on the table, and should not be ruled out
  - There is also the possibility that Russia retaliates, in response to the imposed sanctions, by reducing or stopping its energy exports
- In case the conflict continues, with neither side giving up and no meaningful talks yet in sight, supply chains will likely be at risk and energy prices remain high
  - A pro-longed conflict can keep energy prices elevated, which will likely hurt economic growth more in Europe than in the US, as Europe is more dependent on Russian energy

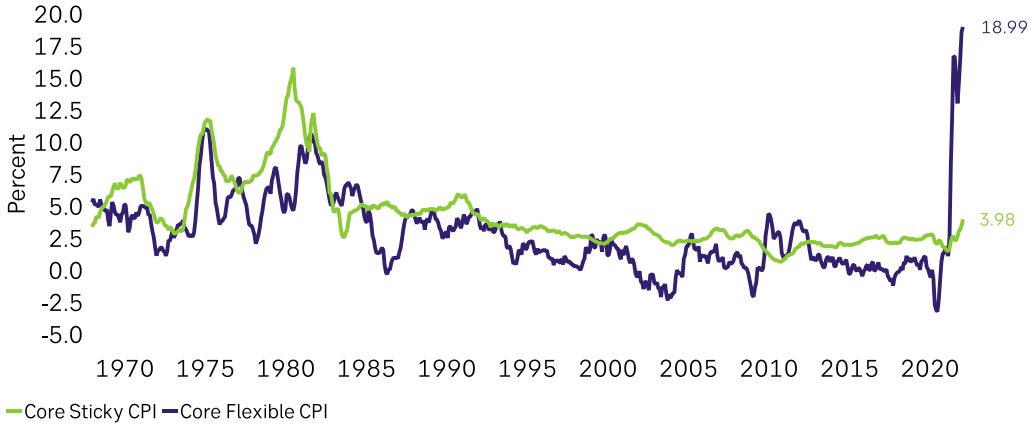
Long-term inflation expectations in the US and EU have risen

- Amid increasing commodity prices, markets' inflation expectations in the US and EU have increased
  - Inflation expectations in developed markets were stabilizing prior to the invasion in Ukraine, but the recent developments has increased uncertainty
- Higher commodity prices have largely driven US CPI flexible prices, but has only led to a relatively small uptick in US CPI sticky prices
  - The sharp increase in flexible prices is a reaction to the current environment and should not be used as an indicator for future inflation
- We have yet not seen a significant spill-overs to other goods and services, but the risk here is that sticky prices eventually begin to experience similar hikes and that inflation stays higher for longer

Figure 1: EU inflation breakevens increased considerably more in Europe than in the US since the invasion of Ukraine

Source: Macrobond, SEB

Figure 2: Flexible prices in the US have spiked, but the increase in sticky prices has been relatively small so far



Source: Macrobond, SEB

In Focus: Sanctions against Russia

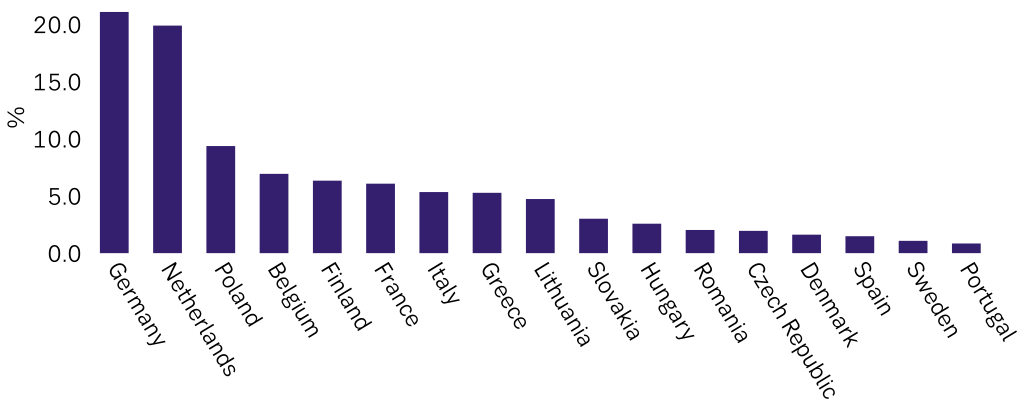
The West imposed sanctions targeting businesses and people affiliated to Putin

- The US, EU and UK, among other countries, have recently announced sanctions on Russia, putting more pressure on Putin to end the war with Ukraine
- Most notably was the US move to sanction the Russian central bank by freezing $630 billion of its foreign currency reserves, effectively hindering it to stabilize the Ruble
- Some of the largest financial institutions in Russia will also be banned from SWIFT, making it much more difficult for them to make or receive global financial payments
  - This will likely hurt both Russia and its trading partners
  - The EU decided to not exclude Sberbank and Gazprombank from SWIFT, because they handle the bloc's payments to Russia for its considerable oil and gas imports
  - In addition, many foreign companies have decided to cut ties with Russia, in order to comply with sanctions and mitigate reputational risk
- Sanctions aimed at Putin's inner circle have been effective, asset seizures together with the fallout of the Russian economy, have seen the wealth of Russian oligarchs fall by $80 billion
  - At the same time, oligarchs have begun to publicly condemn Putin's invasion of Ukraine.

European banks are most vulnerable to the Russian economy

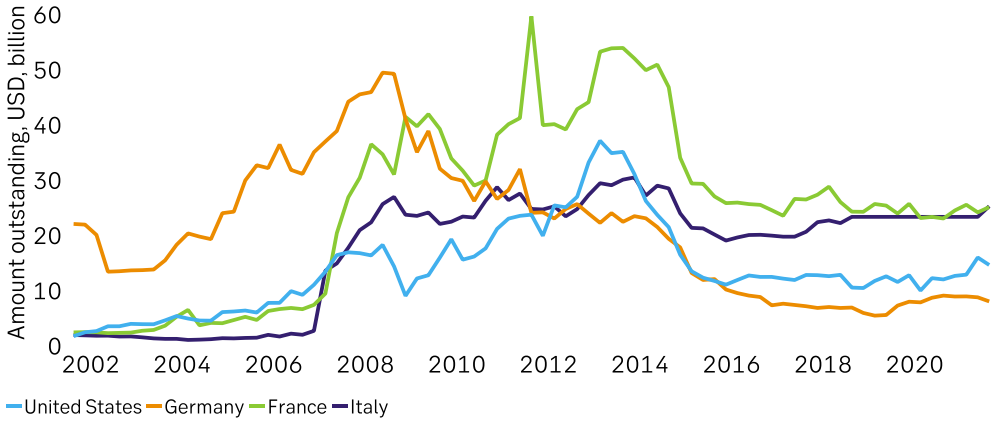
- Italian, French and Austrian banks are the banks with the largest exposures to Russia, measured by outstanding amounts of foreign claims
  - The European banking sector also holds most of global banks' total exposure to Russia
  - US banks, on the other hand, have much more limited exposure to Russia than their European peers.
- Foreign banks significantly reduced their Russian exposure following the Russia's annexation of Crimea in 2014, but some banks have continued to do business there
  - The invasion of Ukraine will likely mean huge write downs for these banks in the coming months and prompt them to potentially exit the market.

Figure 1: Germany is most exposed to oil imports from Russia as a % of total imports to the EU



Source: Macrobond, SEB

Figure 2: European banks are most exposed to Russia, while US banks have little exposure



Source: BIS, Macrobond, SEB

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Asset Class and Sector Views

Developed Market Equities – 12M Outlook

Our 12 month outlook for developed market equities has turned more uncertain due to recent events which could cause a different path for the global economy

Although macroeconomic data is showing a strong recovery from the coronavirus induced recession, which will likely continue as economic activity continues to normalize, the downside risks stemming from prolonged elevated inflation has risen the uncertainty for markets. That is, we are now at an inflection point as inflation will likely remain elevated for longer in 2022 and central banks will have to balance the task of containing inflation whilst also supporting the economy.

Nonetheless, we still expect developed market equities to deliver risk-adjusted returns in excess of developed market government bonds

That is, strong demand and an improving labor market will benefit the asset class. And although rates are expected to rise this year, the pace of tightening monetary policy will likely only take place gradually. So as rates gradually rise and government bonds come out of favor, developed market equities maintain its relative attractiveness i.e. TINA

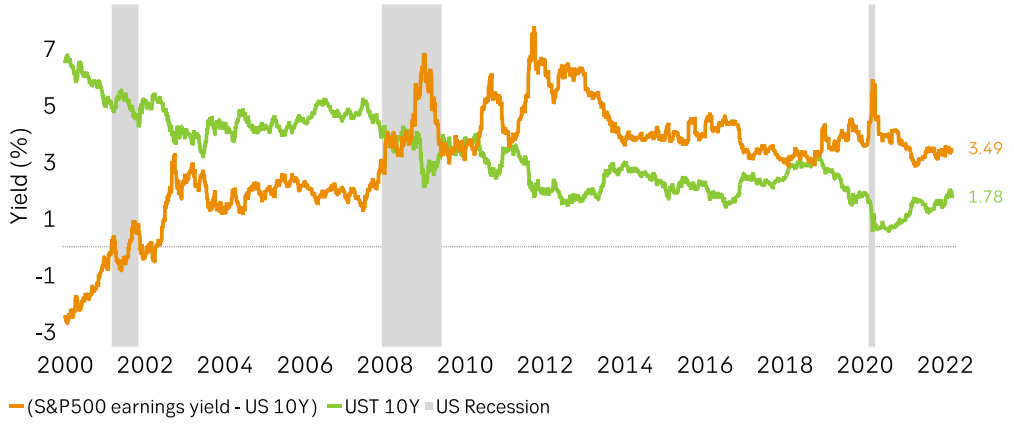
2022 will favor companies that can raise prices despite inflationary pressures and maintain good profit margins

We still expect supply constraints to ease from the coronavirus related restrictions, which should meet the gains in demand. However, given recent geopolitical tensions and rising commodity prices, downside risks have risen of higher-for-longer-inflation. With this in mind, we expect companies that can handle higher input prices to be the winners of 2022. That is, the low yield environment which we have had for years, will not be enough for companies this year.

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

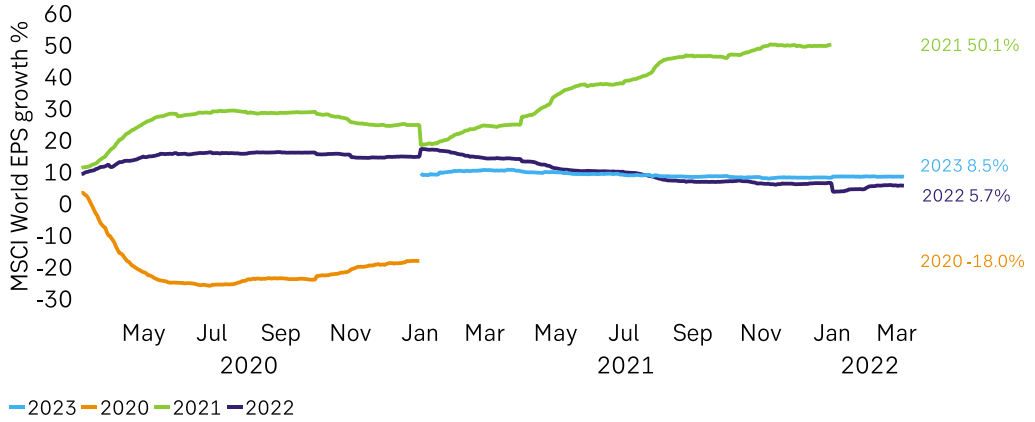
The recent downturn in markets has meant that valuations are now trading at a much more sanguine level. In case the recent geopolitical tensions has a shorter duration, we could see multiples again expand

Figure 1: The spread between US forward earnings yield and the 10Y yield remains elevated. But as inflation could remain elevated for longer, we may see further compression



Source: Macrobond, SEB

Figure 2: EPS growth forecasts remain at decent levels as the market expects continued recovery in the global economy



Source: Macrobond, SEB

Emerging Market Equities – 12M Outlook

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

The growth premium of EM markets relative to DM markets can accelerate in 2022 as inflation and commodity prices will likely remain elevated in this new evolving phase. That is, we see an upside risk for nominal GDP in these regions and can expect further positive earnings revisions. Emerging markets have historically correlated with oil price rallies which in this case would benefit the asset class. The reopening trade is yet not fully priced in for the region and should benefit EM. And as long as the global economic outlook remains buoyant, we expect the asset class to outperform bonds.

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

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

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

Given that US rates are expected to rise we could see the US dollar rise which would put negative pressures on EM equities. But on the flip side, a wider current account deficit in the US as well as overall negative real rates can put negative pressures on the dollar.

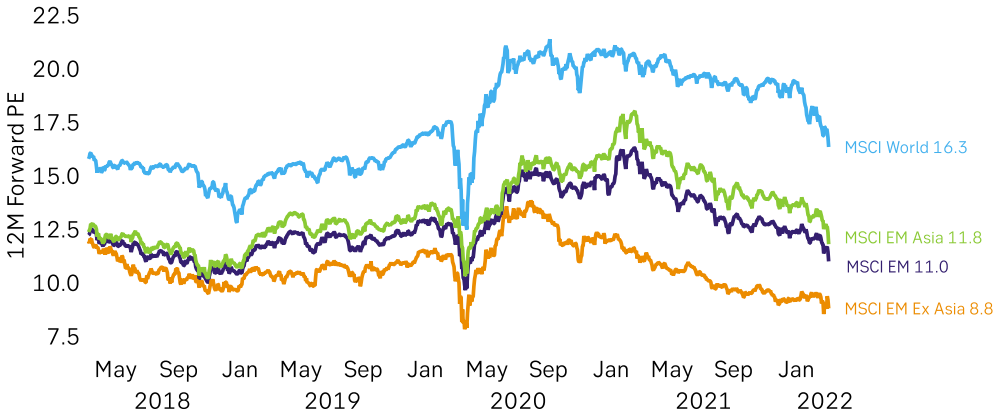
Price levels in EM equities remain attractive relative to DM equities

EM valuation has traded cheaper due to a multitude of challenges last year: zero Covid strategy, property sector adjustment, power rationing and a regulatory adjustment to the corporate profit share. Global investors are still relatively underweight EM after a weak 2021. But we expect to see a turnaround in 2022.

Equity risk premia in the region will likely diminish in 2022

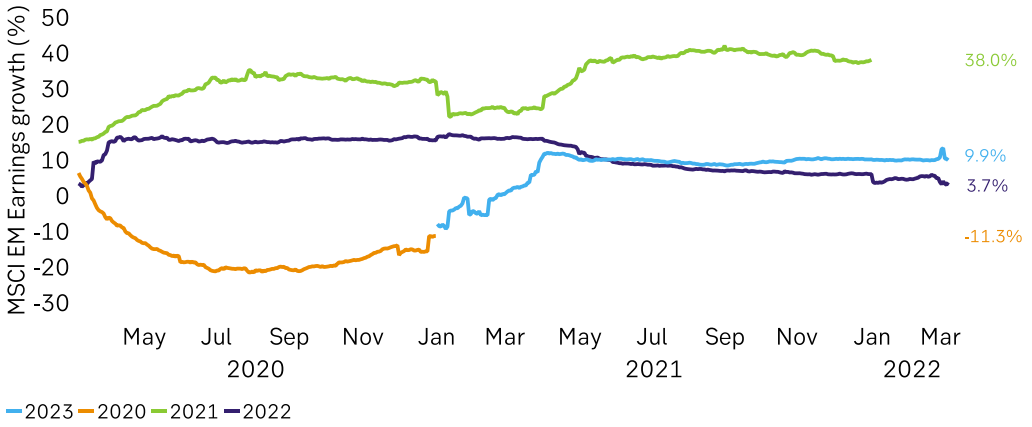
Although all the potential risks are perhaps not fully priced in EM markets, the surprise factor has diminished drastically

Figure 1: Emerging market equities can now come into favor as an inflationary environment with higher commodity prices could benefit EM regions



Source: Macrobond, SEB

Figure 2: In our view EPS estimates for 2022 are too low. We expect the reopening of countries in the EM, together with strong external demand to support the asset class



Source: Macrobond, SEB

Corporate Bonds – 12M Outlook

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

The relative attractiveness of High Yield and Investment Grade bonds to equities has diminished given that risk-adjusted potential remains weak. Credit spreads have recently widened due to increased uncertainty from the war in Ukraine and sanctions on Russia. Moving forward, further spread widening is now a risk as credit profiles are at a higher risk, while the risk-reward for equities is higher.

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

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

We expect credit profiles to improve as activity normalizes

In particular, bonds that have been most affected by COVID-19 and been lagging in the recovery – such as travel companies. However, we remain wary of the risks from geopolitics, supply-chain disruptions and a slower economic recovery

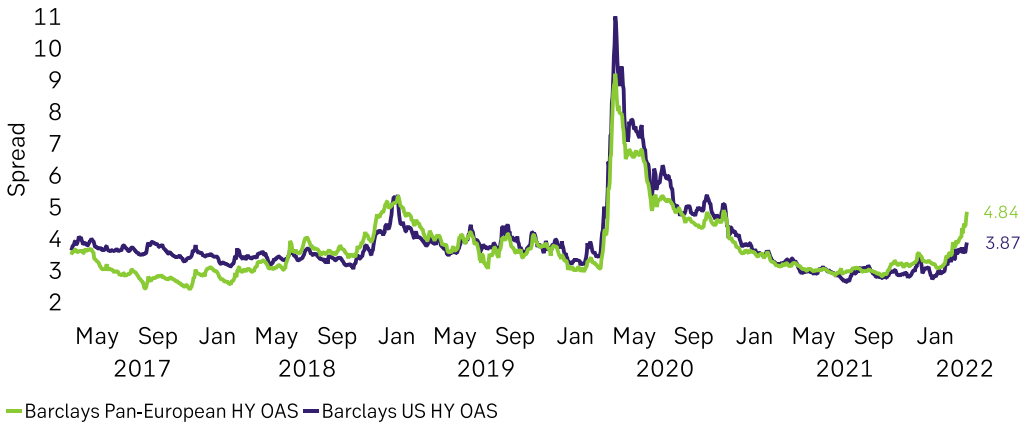
Liquidity in the market can get more challenged

Recently we have seen financial conditions deteriorate due to the war in Ukraine. The Treasury curve has recently flattened as bond markets are more cautious on the outlook. That is, with a tightening monetary policy ahead we could see further volatility onwards.

We expect default rates to stay low moving forward

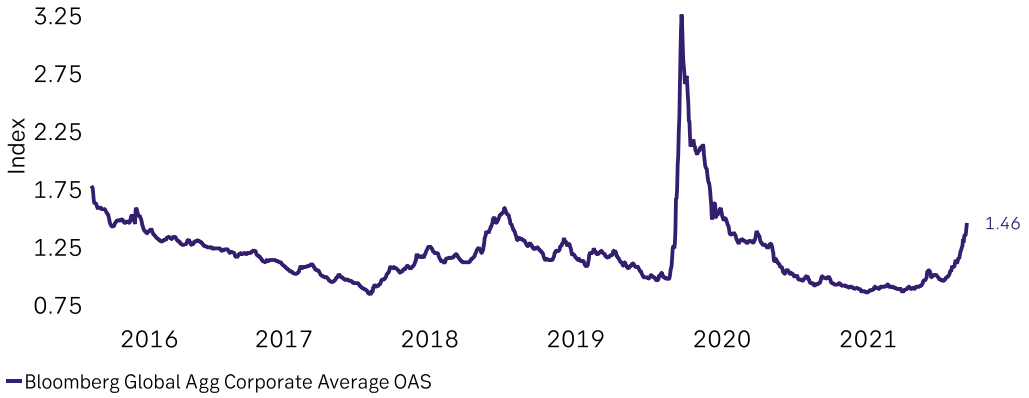
As we are as of today at an expansionary phase of the cycle, we expect it is unlikely that default risks will be priced aggressively. However, with elevated inflation the downside risks have increased

Figure 1: HY spreads widened particularly in Europe due to the war in Ukraine. In our view there is still further risks of spread widening in case the situation deteriorates



Source: Macrobond, SEB

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



Source: Macrobond, SEB

Government Bonds – 12M Outlook

We hold an underweight to Government Bonds in favor of Equities

Treasury yields are likely to remain at lower historical levels as the FED shifts policy. Tapering will begin at a pace which can end by mid-2022. Markets are expecting the Fed to hike rates five times in 2022. Over the next 12 months we expect the long-end of the curve to gradually rise while the short-end will rise at a slower rate as the Fed will likely calibrate the rate hikes carefully. As such, we expect a continued steepening of the yield curve and continued outflows from government bonds into equities. Moreover, given the low yields and high prices for government bonds, the asset class provides less risk diversification potential in the portfolio than previously held.

Real yields can remain negative even as nominal yields pick up as inflation breakeven remain high

US yields have fallen over the last month as markets are expecting a slower rate hike. While the US 10Y inflation breakeven rose as inflation fears increased. Given these moves, we have seen real yields fall back to further negative levels. Real yields can rise from these levels without worrying markets. But while a gradual rise in real yields reflects the fact that the economy is improving, a fast rise in real yields may spark volatility for equity investors. Nevertheless, we expect that moderately elevated inflation, together with rising nominal yields, will keep real yields below zero for the coming months. As such the low real yield environment will keep a lid on the potential return for government bonds.

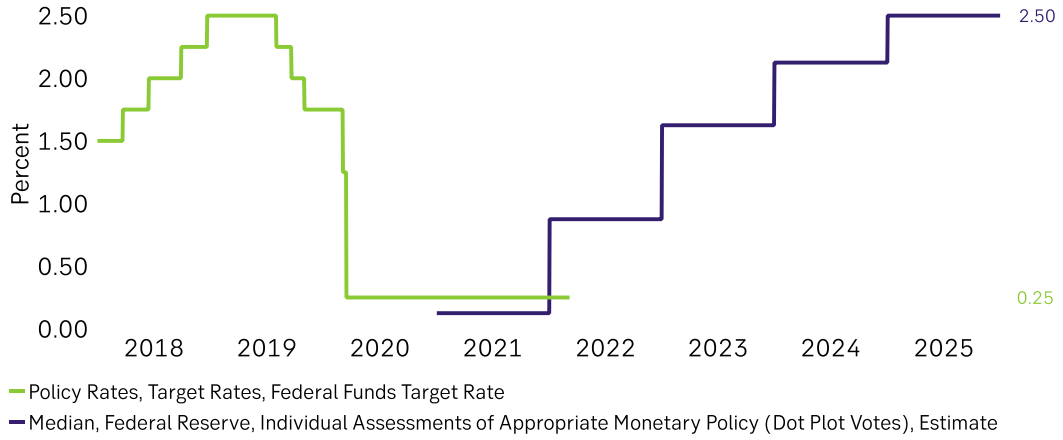
Over the long-term government yields will remained capped due to increased fiscal debt in developed markets

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

Figure 1: Real yields have moved upwards, but remain negative. Treasuries are thus expected to underperform over the year

Source: Macrobond, SEB

Figure 2: According to the Fed.s dot plot the pace of rising rates is slower than the markets expectations



Source: Macrobond, SEB

Region Overview

Regional equity positioning

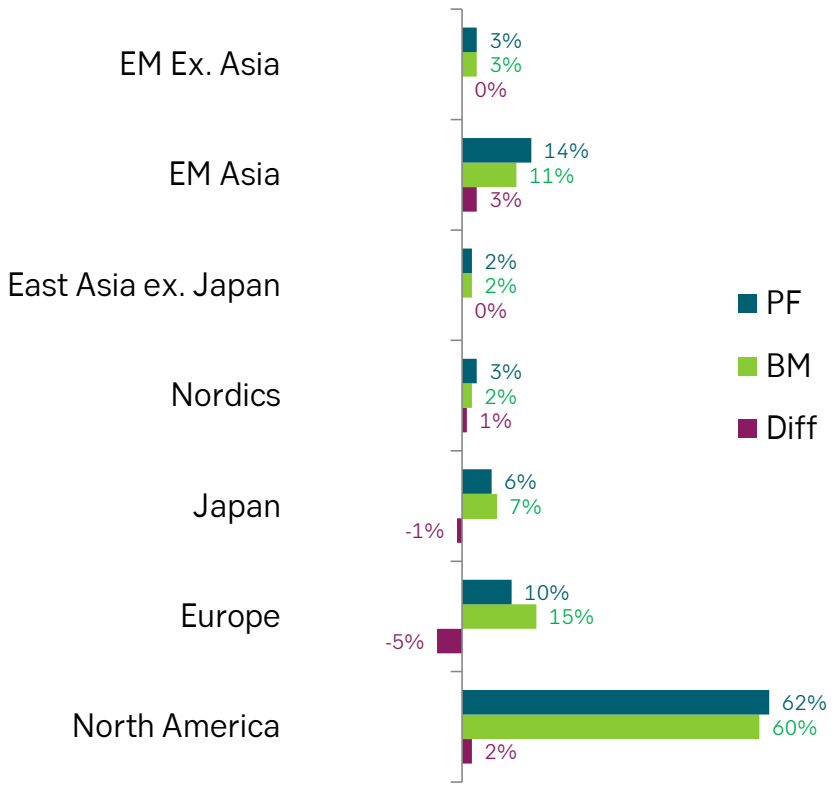
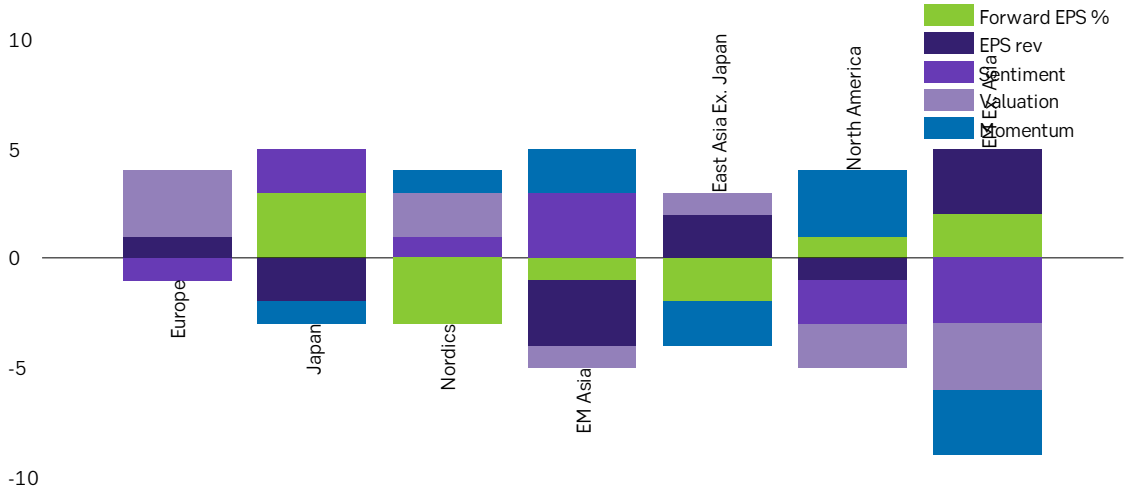


Figure 1: SEB House View region score*



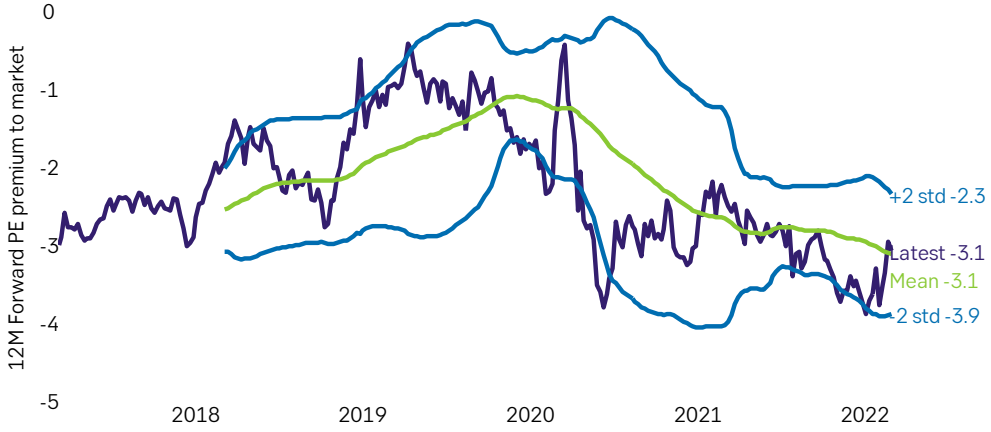
* Ranked by total score with highest score starting from left

EM Asia – Overweight

EM Asia will likely benefit from further policy easing in China together with higher commodity prices and diminishing equity risk premium

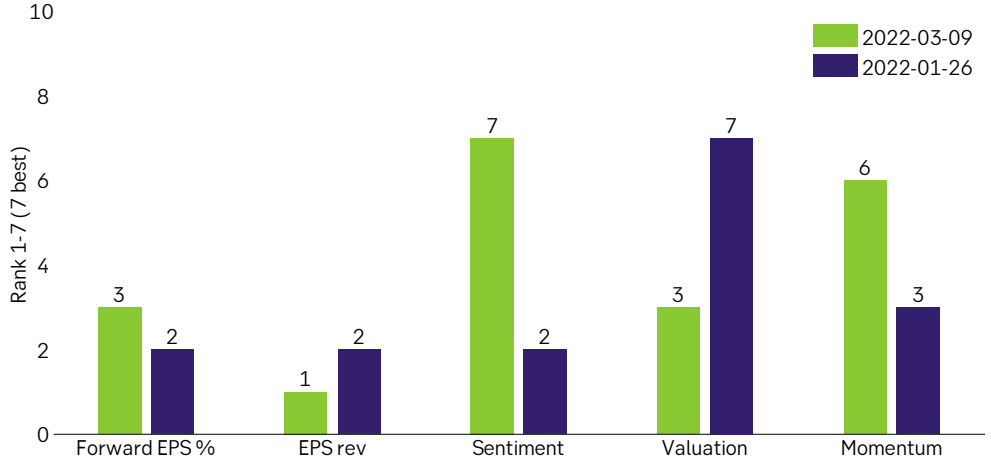
- Chinese policymakers announced at the NPC to step up monetary policy and fiscal spending to support economic growth
- Higher commodity prices will favor EM exporters in terms of growth
- The reopening trade is yet not fully priced in and should benefit the region
  - Global investors are still relatively underweight the region which could add further optionality to EM Asia equities
- Asian central banks are at a different starting point than DM and can support the economy with stimulating monetary policy
  - But real differentials should benefit the currency and lead to strength in CNY
- We expect to see more positive earnings revisions as we see an upside risk for nominal GDP given rising inflation and rising commodity prices
  - We also expect the growth premium relative to the US to accelerate

Figure 1: Standardized relative valuation – Current constituents



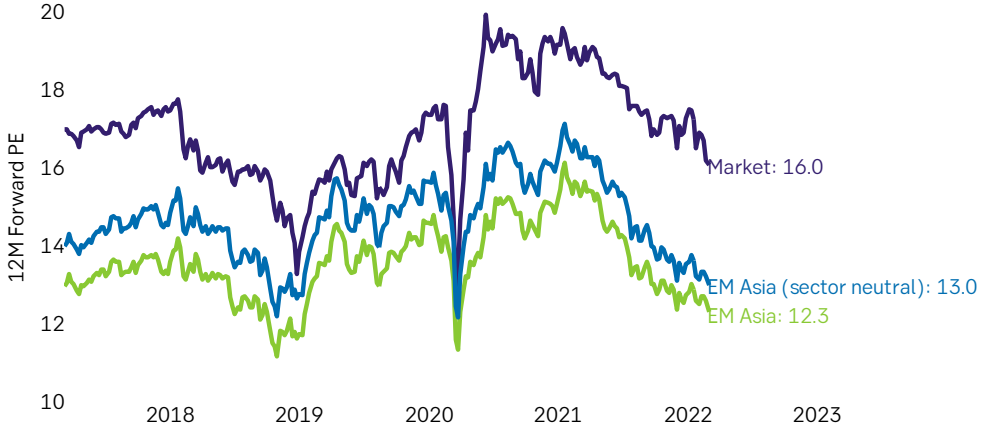
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



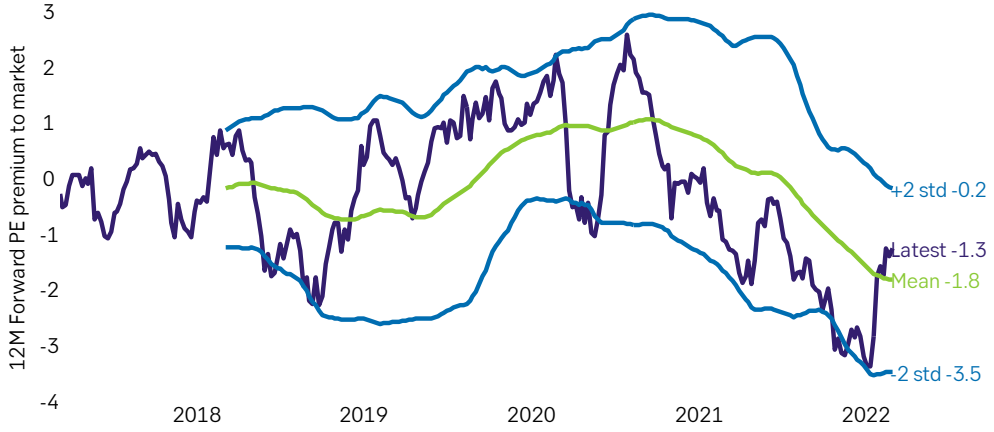
Source: SEB House View

EM Ex Asia – Neutral

Higher commodity prices could prove a tailwind for EM Ex Asia

- The region has no material direct linkage to the Russian economy
  - But instead has a broad basket of primary product exports which can deliver positive GDP improvements in trade balances
    - Through stronger growth and improvement in fiscal and current account balances
- Historically EM Ex Asia correlates strongly with oil price rallies and corrections
  - And in case of higher expected inflation and an economic deceleration, the region has historically been the biggest beneficiary
- In our model, the scores on the EPS revision ranks at the top in comparison to other regions, as well as a strong score on the EPS outlook
- However, the region is struggling with soaring inflation – which higher commodities are now adding towards – and could force central banks to pivot more quickly towards normalizing policy

Figure 1: Standardized relative valuation – Current constituents



Source: SEB House View

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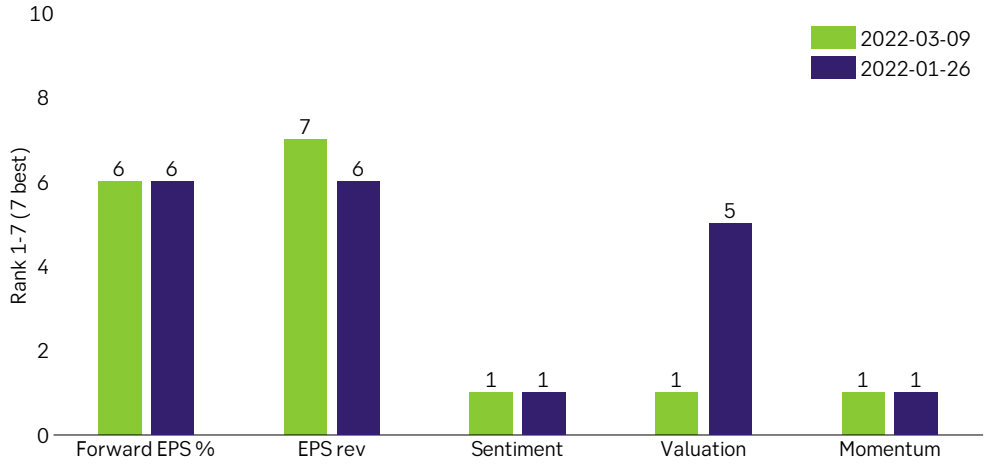

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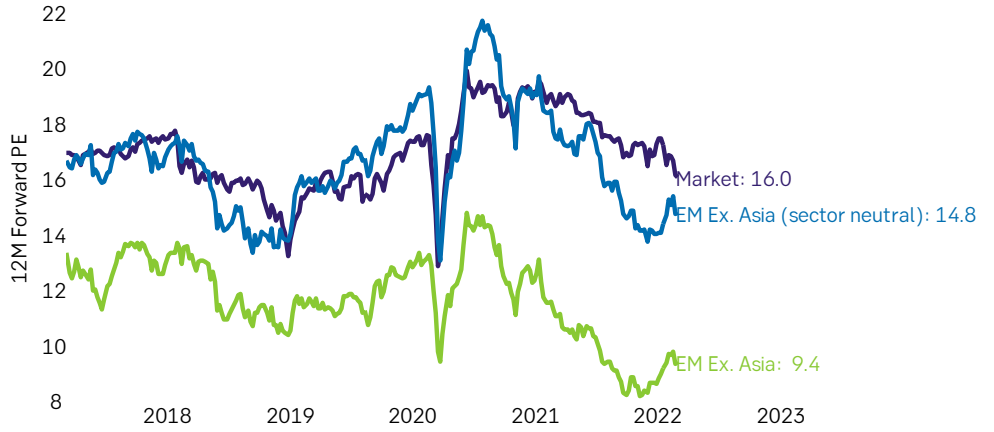


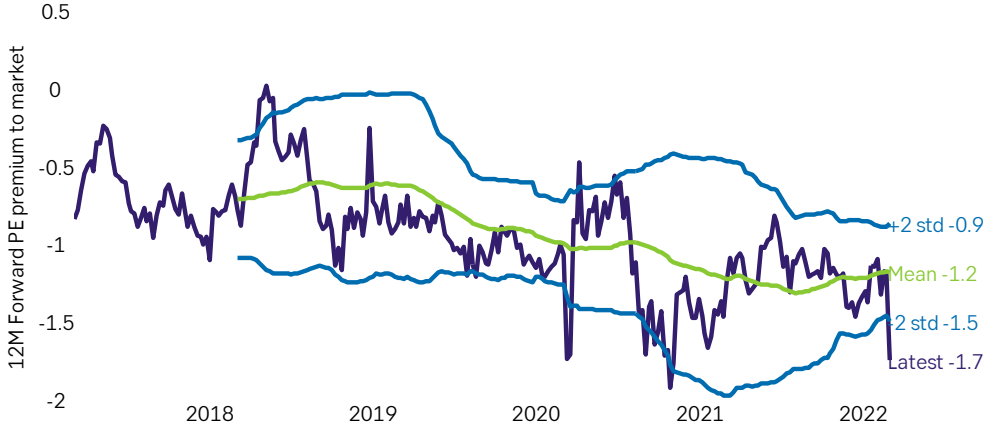
Source: SEB House View

Europe – Underweight

European equities are most vulnerable to the Ukraine-Russia war

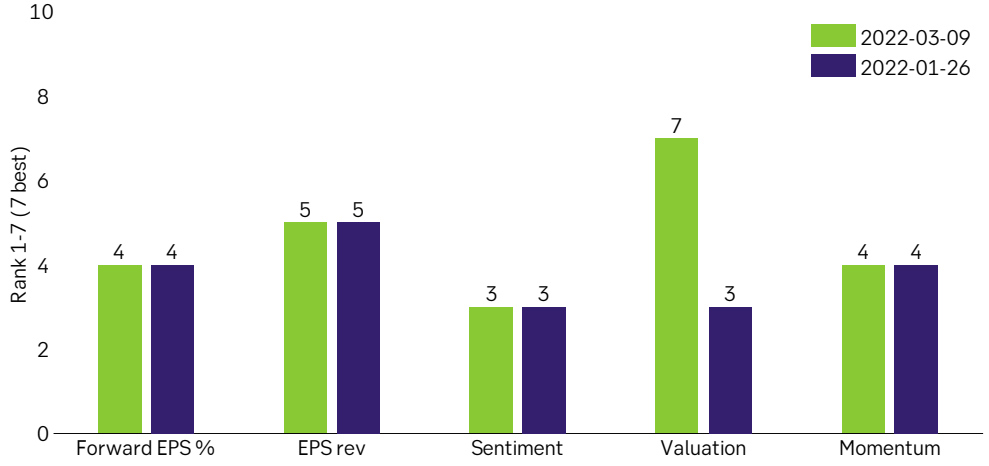
- The current war in Ukraine and sanctions on Russia has the largest material impact on European growth prospects in comparison to other regions
  - Europe's overall natural gas come from Russia and it's reliance on Russian oil is also significant
  - However, the secondary effects through rising inflation, supply chain distortions and slower consumer spending is the most significant consequence
- And the region which is dominated by banks can face further headwinds as the ECB struggles to support the economy while balancing with rising inflation from higher energy prices
- On the positive side, latest European macro indicators were rebounding as the economy reopened from corona related restrictions
  - And the region has already priced in a very pessimistic outlook
- However, a deepening of the conflict will likely dent European GDP as the region has a larger dependency on Russian energy and closer ties to Russian industry

Figure 1: Standardized relative valuation – Current constituents



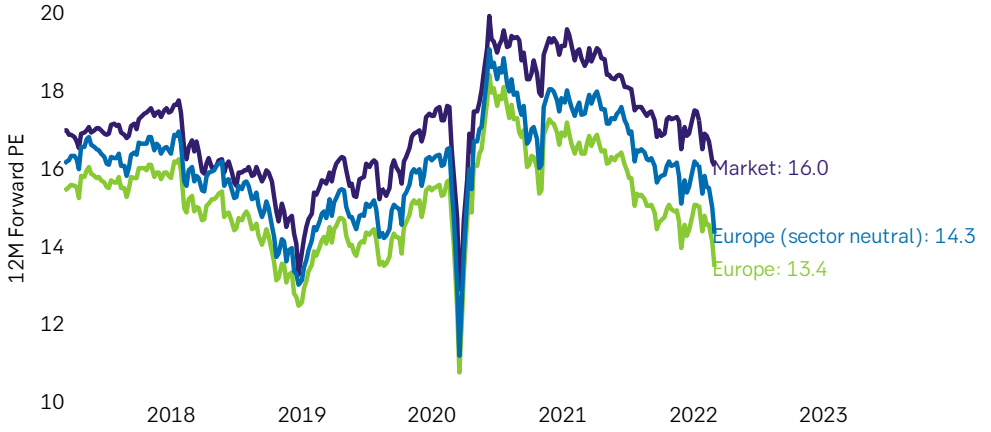
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



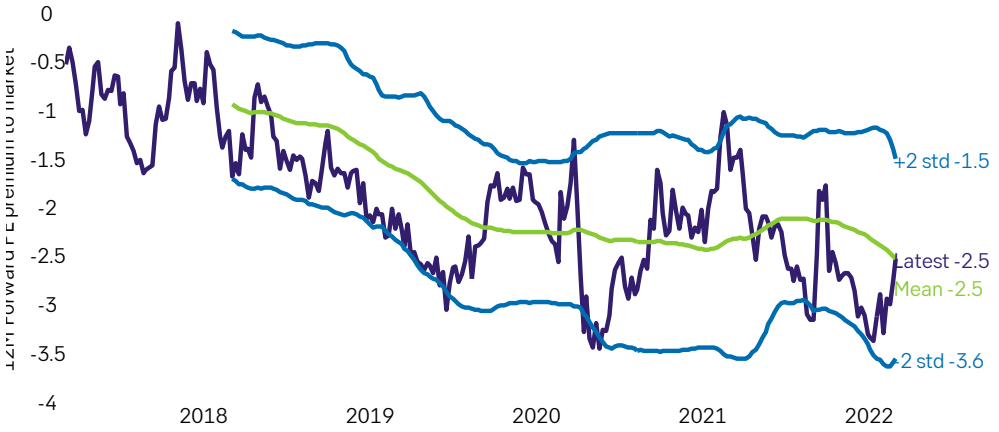
Source: SEB House View

Japan – Underweight

Elevated oil prices will likely lead to negative sentiment in Japanese equities

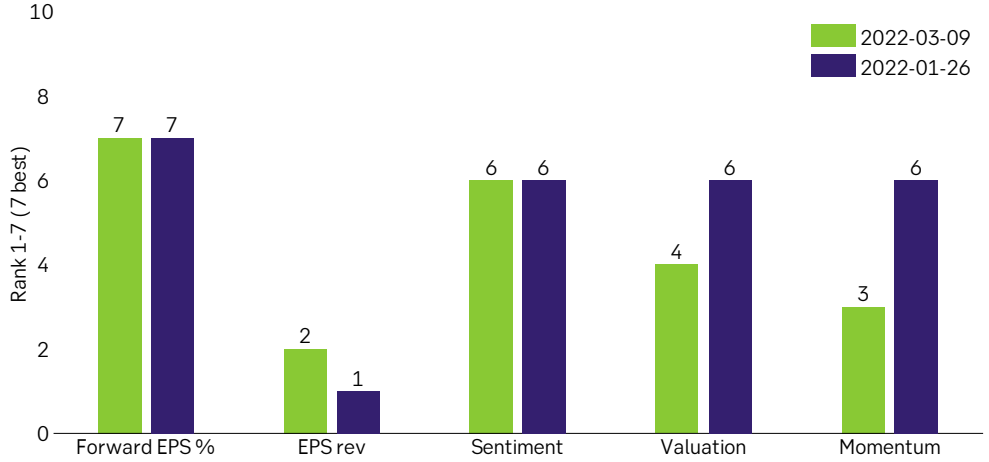
- We have seen a sharp deterioration of economic momentum in the country
  - Latest PMI plunged as business sentiment deteriorated due to strict infection control policy in combination with low booster vaccination rate
- Although we could see a bounce back in 2Q as the Omicron wave starts to fade, rising cost pressures and uncertainties caused by the Ukraine war will likely hinder some of the expected recovery
- The political backdrop is yet not very supportive for the equity market
  - That is, we do not expect a pickup in domestic activity relative to global activity
- However, we note that the market is relatively cheap in comparison to the overall market as it is a traditional play on the global cycle
  - But EPS revisions have rolled over as we have seen further negative revisions
  - And US-Japan rate differential and current account could lead to weakness in JPY
    - Which has historically had an inverse correlation to Japanese equities

Figure 1: Standardized relative valuation – Current constituents



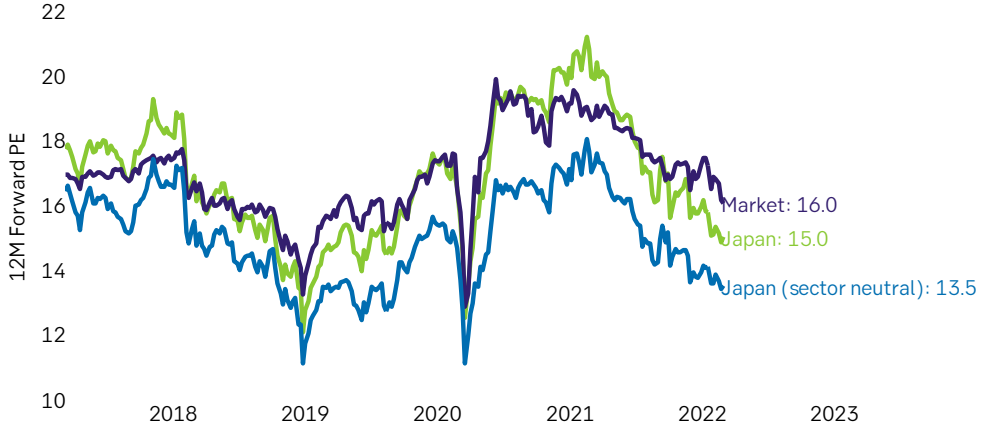
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



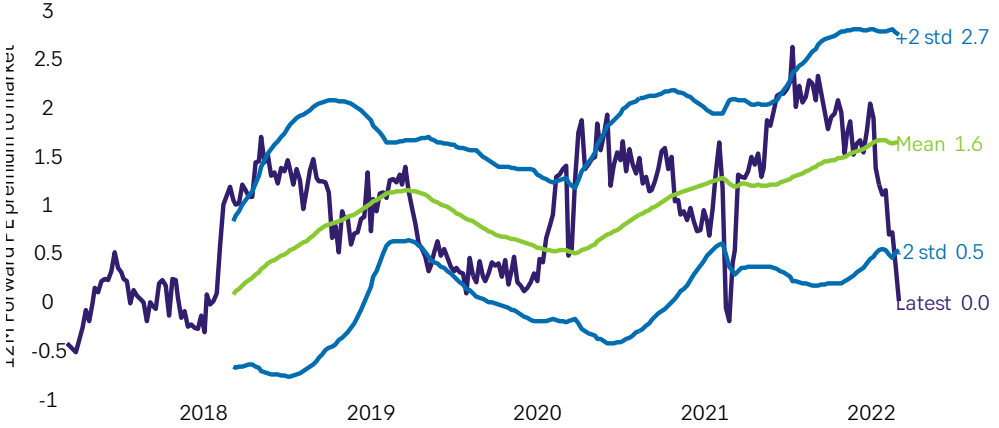
Source: SEB House View

Nordics – Overweight

We remain overweight in the Nordics despite the recent setback in the region

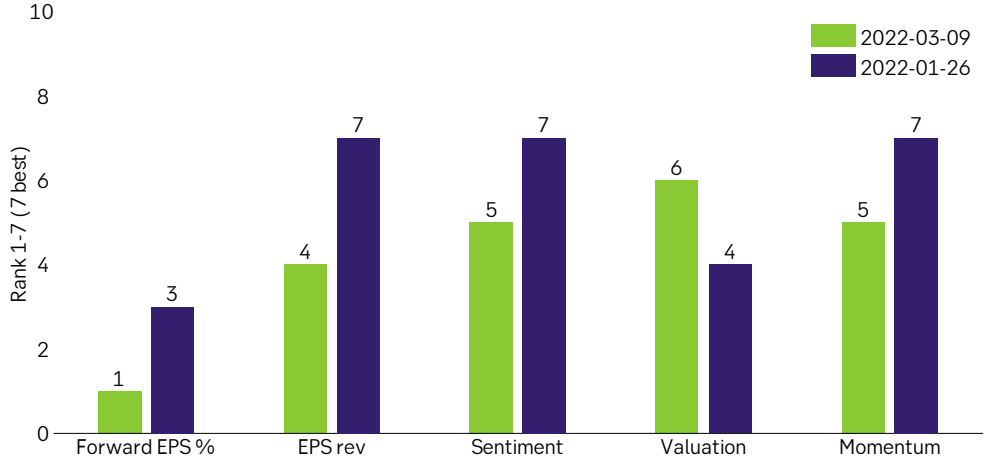
- As long as the global economy remain in above trend growth, the region should benefit from strong exports
  - The Nordics has a much higher export exposure to Europe than to Russia
- The SEK has recently become extremely cheap and undervalued due to the Russia-Ukraine war
  - That is, the Nordic currency has been trading as a proxy for the Russia-Ukraine war despite not having strong ties with Russia
- The supportive economic outlook remains central to our overweight
  - As the reopening will be associated with a pick up in domestic demand
  - Which should also boost the case for a normalization in Riksbank monetary policy
    - Even if the Riksbank is less hawkish than the ECB or FEd
- Our model signals that equities are now trading at multiples below the market valuation, whilst still having long term potential

Figure 1: Standardized relative valuation – Current constituents



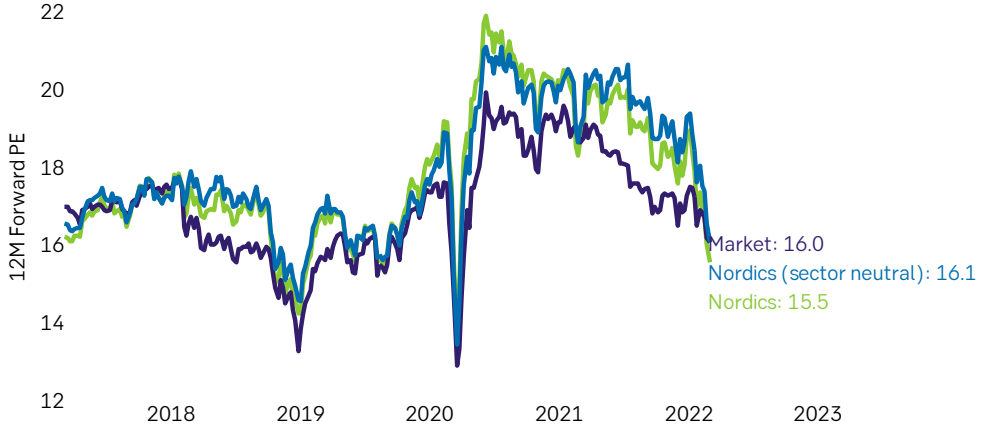
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



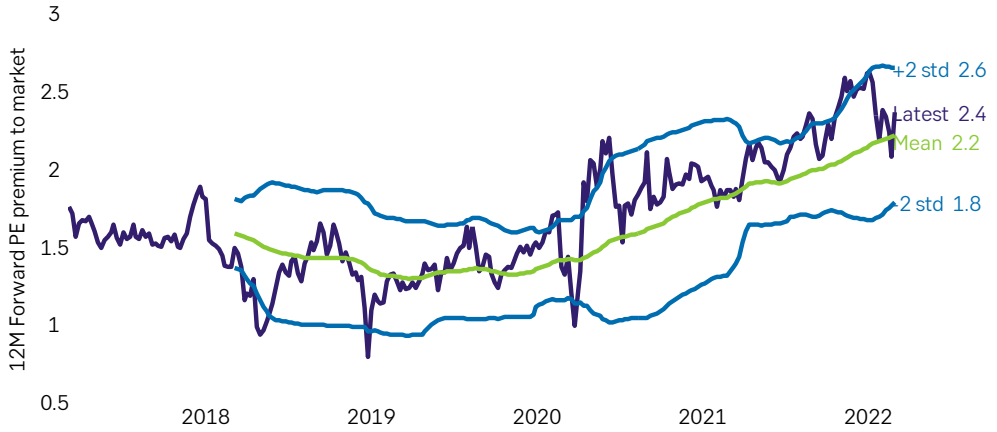
Source: SEB House View

North America – Overweight

US equities will likely outperform European indexes as US companies have a low direct exposure to Russia

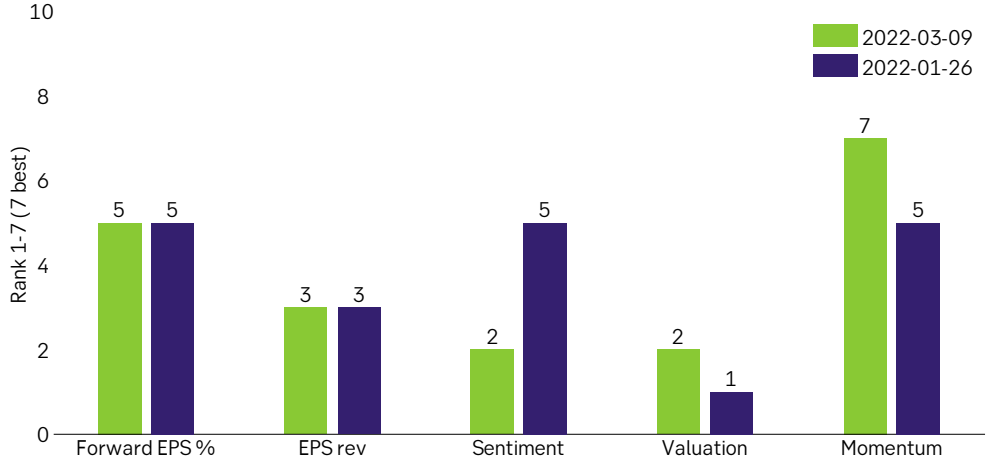
- The Ukraine war and sanctions on Russia has a low earnings risk for US companies
  - However, elevated inflation due to stubbornly high energy prices in combination with an aggressive Fed could dampen sentiment
    - Nonetheless, bond markets are now suggesting a slower path for the Fed towards tightening monetary policy
- Nonetheless, macro data in the US remains above trend
  - With strong labor market, buoyant consumption and upbeat earnings outlook
  - Prolonged inflation and supply chain disruptions remain key risks for the region
    - However, the Fed will likely move ahead to curb inflation at a moderate pace
- The region is a defensive play during elevated geopolitical risks
  - The worst of the downturn is perhaps over as its valuation is trading now closer to a support level

Figure 1: Standardized relative valuation – Current constituents



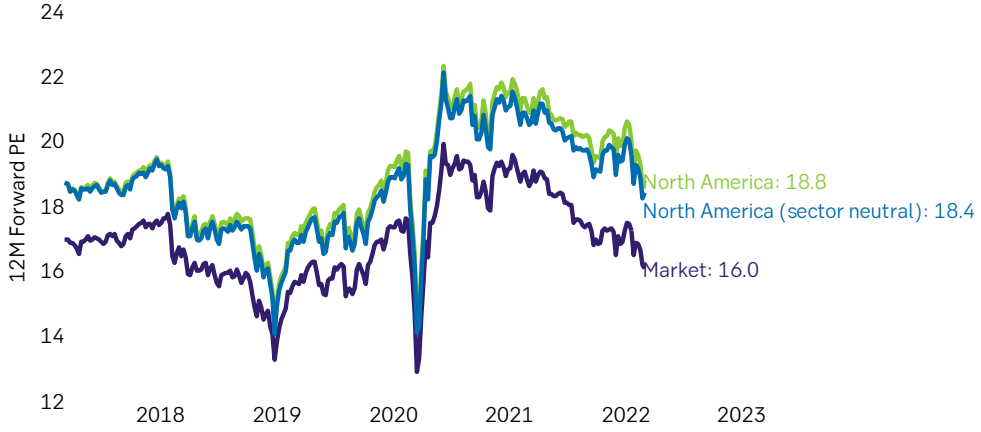
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



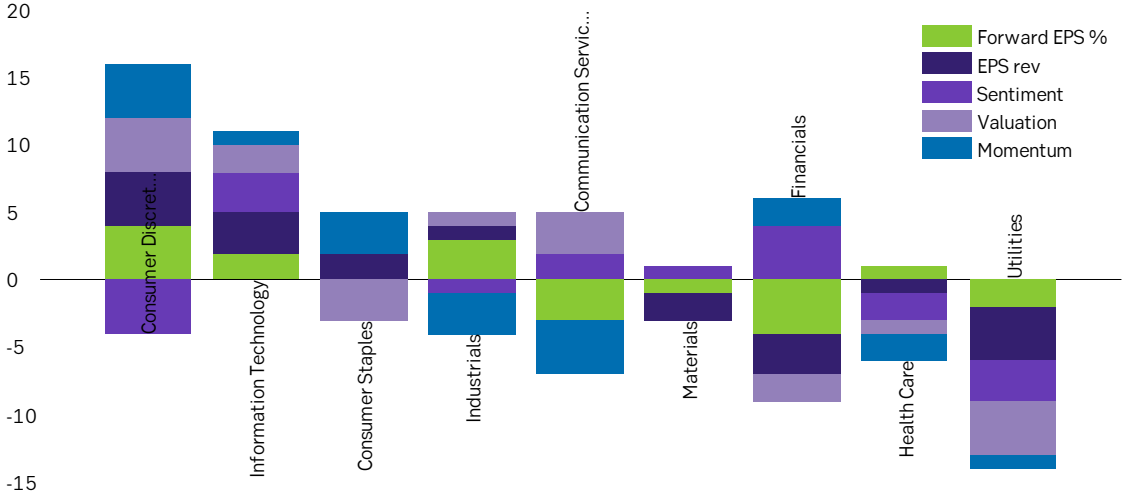
Source: SEB House View

Sector Overview

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

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

Figure 1: SEB House View sector score



Source: SEB House View

Overweight – Materials, Health Care and Industrials

We lift our weight to materials as we expect the sector can deliver better risk-adjusted potential in this period of volatility

- The sector can catch-up to the broader market as China growth momentum can now pick-up with a more accommodative policy stance
- Relative earnings revisions appear to be stabilizing and valuations look attractive

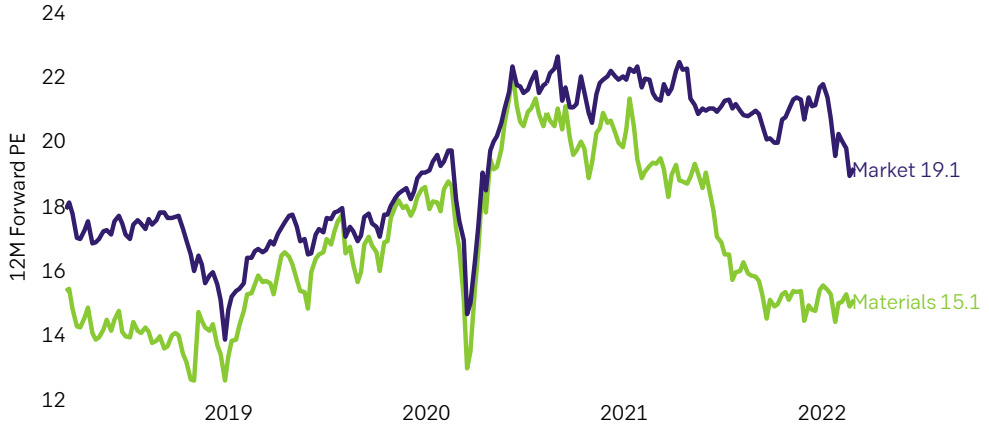
Industrials can benefit from strong EPS growth outlook

- Companies in the sector could see capital spending given earnings support and government stimulus
- Parts of the sector should benefit as travel restrictions can be removed, but higher oil prices and whether companies have the pricing power to offset this is challenging

Health Care remains a defensive play and attractive in terms of valuation

- Profit margins are exceptionally strong vs the market given strong operating leverage and are better placed to withstand rising input pressures
- Political risks remain low for the time being

Figure 1: Materials is now attractive in this new phase of the business cycle

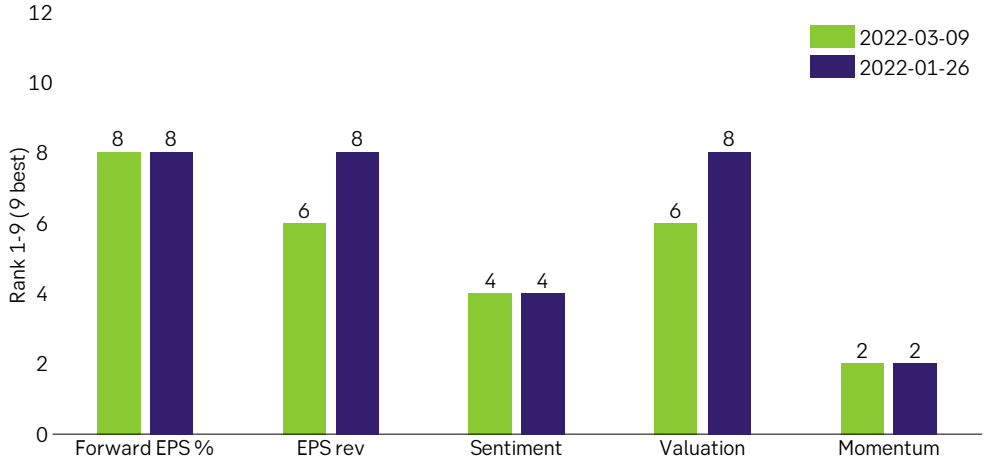


Source: SEB House View

Figure 2: Health Care remained more stable during this volatile period

Source: SEB House View

Figure 3: Industrials maintains strong forward EPS growth



Source: SEB House View

Underweight – Consumer Staples and Utilities

We remain underweight in Consumer Staples

- We believe it will continue to be out of favour as investors are more inclined to buy sectors that offers better earnings growth, sometimes also at a lower valuation
- Rate hikes are planned for this year – the sector remains inversely correlated to bonds
- With input costs likely to rise, due to rising raw materials, the sector will come under pressure

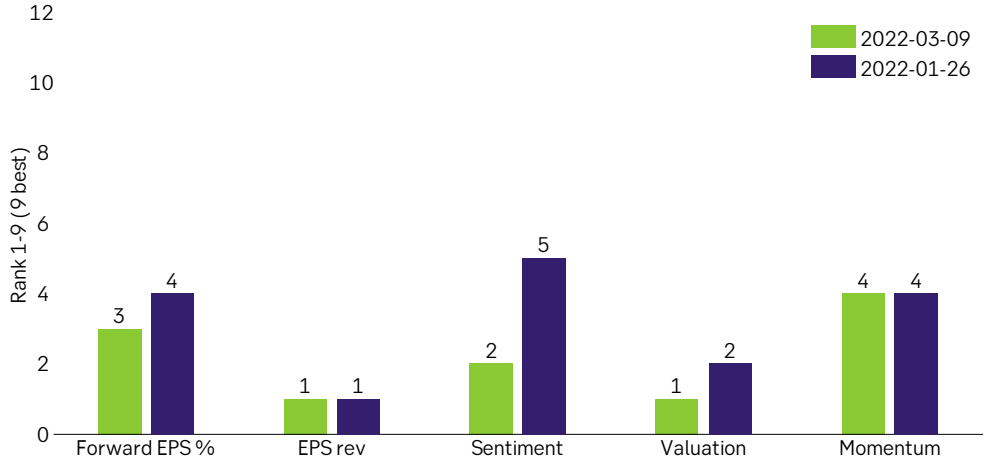
The outlook for Utilities remains weak considering the new environment

- Fundamentals are weak and the market is more likely to turn out of the sector
- Our view on treasuries is clear: yields are more likely to move up than down.
  - On the margin this will be negative for the bond proxy sector where predictable cash flows are discounted based on long dated yields
- The valuation has increased for Utilities since the breakout of the war in Ukraine and remains unattractive

Figure 1: Consumer Staples is now trading at higher levels than the overall market

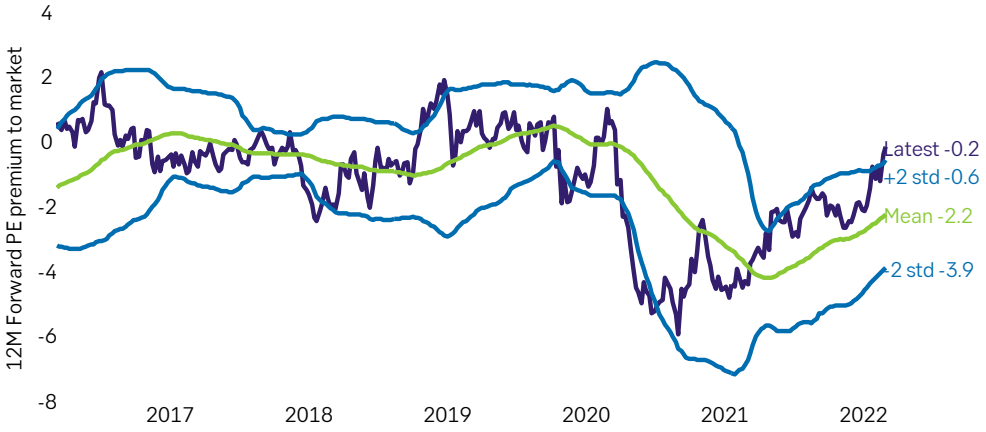
Source: SEB House View

Figure 2: Utilities scores the lowest in our House View Sector model



Source: SEB House View

Figure 3: Utilities relative valuations is now trading at toppish levels to its history



Source: SEB House View

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