SEB House View

24 August 2022

SEB

Overview

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Market and Fair Value Indicators

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A split landscape

Investment Regime: a phase of transition, complicated.

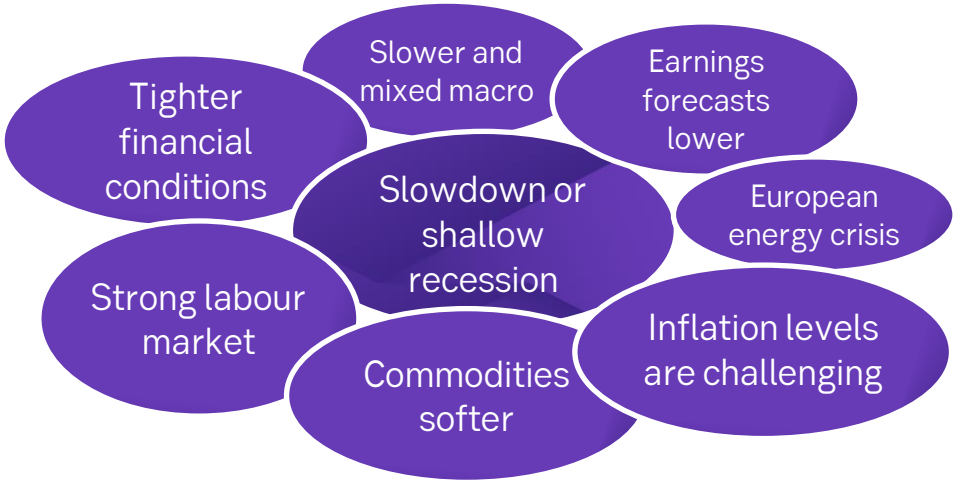
- Markets are in a transition from a Covid world with low/zero interest rates and no inflation to super strong inflation and firm central banks
- At this time visibility is limited both on inflation and macro
  - We have markets that have discounted a negative outlook and probably discounted a mild recession, and accordingly to that our low risk utilization – all in all markets have come down
- The coming trend will be driven by the combination of growth risks and inflation
- The three major geographic areas have different outlooks and there is a challenge in that the world is very divided
- The US is doing reasonably well, macro momentum has slowed, Fed has been active and inflation will probably be lower in six months – at least if we believe markets
- Europe is in a different position, its economy is weaker, a global trade slowdown is probably a drag on the region's growth as it is more export-dependent and the inflation situation is very negative. Consumers will have a hard second-half of 2022
- China also has problems: the property market is in a worse condition than feared, the business cycle has not accelerated after Covid, PBOC adjusts its policy and growth is too low. However, we don't think that it ends here, there is probably more to come.

Risk utilization: We stay close to neutral, at 55 %

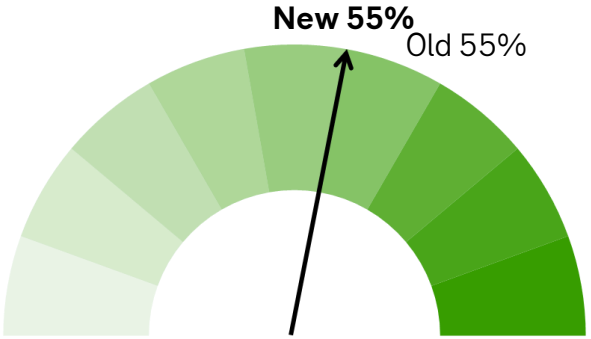
- The next steps in markets are to a very large extent decided by what the FED decides
- The FED's forecast for monetary policy is rather benign with a peak in tightening in a few quarters
- The jury is still out on the actual inflation, wage growth is strong and the FED wants to see lower inflation before shifting its policy. Until that happens, markets will have to live with tightening.
- All in all, markets are lower, some macro is holding up, but it is a tight rope, so conviction in either direction is not super strong, for us that means that we stay close to neutral.

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: FED policies hold the agenda

The US risks a recession, EU probably is in one and China has issues

Leading economic indicators point to a slowdown in the global economy amid record-high inflation, the war in Ukraine and China's weaker-than-expected growth. This has led to markets starting to price recession risks, very much so in small caps and the EU. The US economy shrank in the first two quarters, which raised concerns about recessions in other economies as well, but also sparked hopes of abating US inflationary pressures and a Fed pivot. The important question is by how much and fast the Fed will hike rates to deal with inflation. Until this clarifies we focus on how bond markets price inflations risks. Yields have edged up, which probably is an effect of low liquidity as inflation break-evens are low.

Inflation will need to drop before central banks turn less hawkish

Inflation expectations have been falling, which is good news for central banks as they strive to anchor inflation expectations close to their respective inflation targets. Despite falling expectations, the Fed will not shift its policy unless it sees actual inflation returning to more acceptable levels. Markets currently discount a lower policy rate by the end of 2022 than the Fed's median dot-plot projection. However, as the inflation situation depends on several factors and is very fluid, this can change very quickly. Yields will likely remain volatile. But again, the situation differs globally, the US has the best possibilities.

Earnings is a matter of discussion that has to be resolved.

Earnings estimates are still at high levels, even after we have seen a slight drop, and despite the recent sharp declines in PMIs and higher recession risks. EPS revisions normally tend to follow PMI data. This suggests that markets are either too optimistic or complacent. Although earnings estimates have started to slightly fall in recent weeks, we believe that estimates could face further downward revisions from current levels. We have had extreme margin levels and an important part of high earnings comes from commodity sectors. Margins will most likely be compressed as the economy rebalances after the Covid period and lower earnings in cyclical commodities will change to an even lower level.

Macro A split world, advantage US	• US enters a technical recession while EU Q2 GDP growth beats consensus • GDP forecasts remain decent, but face high uncertainty in the coming months • Falling PMIs, demand and commodity prices point to receding inflation ahead
Central banks A decisive road to tightness	• FED will most likely continue to hike rates until inflation falls • Financial conditions slightly loosened in July, but more rate hikes will tighten conditions, a cold climate for markets
Politics US-China tensions increase geopolitical risks overnight	• Russia's gas squeeze is now Europe's biggest concern as a complete cut-off would send the region into a recession
Corporates Risk for negative earnings revisions	• Earnings estimates remain high, despite weak PMIs and recession risks • EPS will be challenged by margin-compression. • As yields remain volatile we monitor multiples and valuation gaps

RISKS Persistent inflation | FED policy mistake | Global recession | Political risks

Asset Allocation

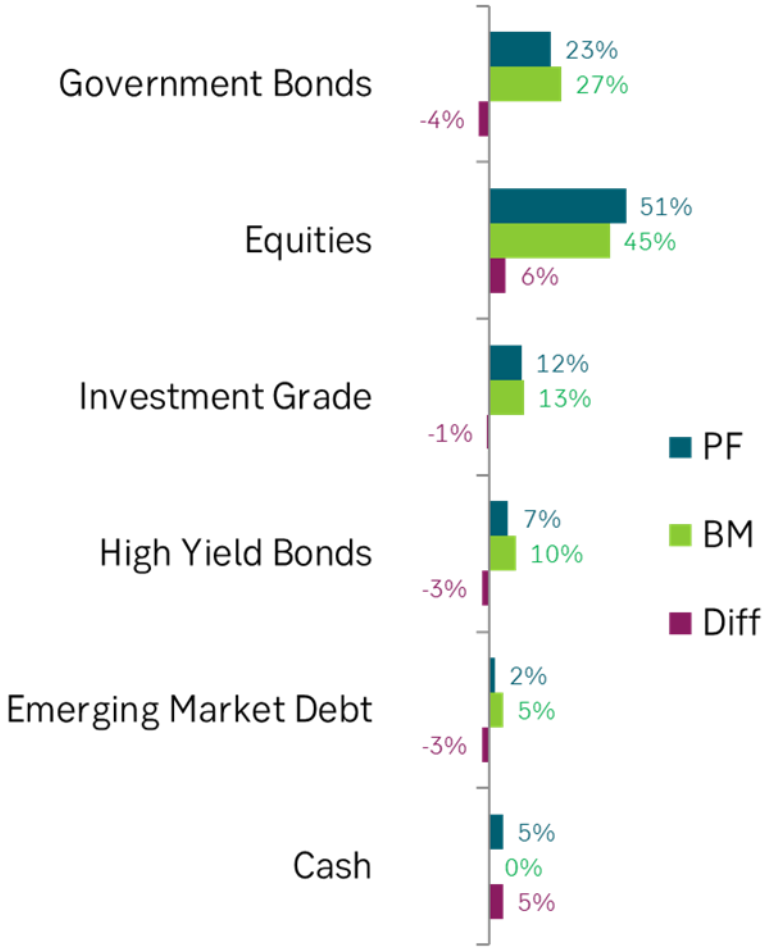
Markets are still challenged and as risks have decreased, we still prefer to focus on equities being a somewhat inflation resilient asset

- Bond markets and inflation have been the drivers of equity markets
- The recent rebound in markets can be labelled as a bear-market rally, but the macro landscape in the US can prove to be resilient enough to carry markets
  - In the slightly longer perspective equities is the asset class with the best inflationary characteristics, however, uncertainty prevails as the inflation outlook for this year is still is an open question
  - Potentially better inflation news in the US is a possible tailwind for the asset class
- Markets have been slightly trendless in terms of factors, this probably signals that the transition to a new landscape is underway
  - We expect markets to perform well overall in the next 12 months, once we have passed the uncertainty we are currently facing
- We have seen a set of downward revisions of growth forecasts, which is usually not a good sign, but markets have already priced some of the effect
  - EPS forecasts are slowly moving lower and the price support is a fact, levels are still competitive compared to bonds
  - If bonds stabilize, as they seem to do, that will help stocks to stabilize
    - ... and then equities will resume a quality, dividend and growthy trend

Government bond markets is moving in a trading range, but not moving higher

- We maintain an underweight in government bonds as there is still uncertainty in the inflation outlook and the risk-reward for equities looks more compelling
  - However, the level of yields is somewhat stable which indicates that a lot of the issues with inflation are already priced in
- We underweight the corporate bond markets as the climate still has recession risks and spreads continue to be very volatile
- Emerging market debt is not interesting now as the strong USD will still have support from a better policy outlook

Model Portfolio



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

Regional equity allocation

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

- We are overweight in the US because it benefits from its safe heaven status
- We also see strong equity flows from the EU to US
- US macro data, especially for consumers, has proven to be resilient, despite the challenging backdrop of higher inflation and geopolitical risks, which is another advantage
- The stable USD is also a strong case for keeping US assets, the FED has created confidence
- The US economy is the least affected by inflation, albeit some of the sector composition is negatively impacted by higher interest rates
  - A stabilization in bond yields would lead to some optionality

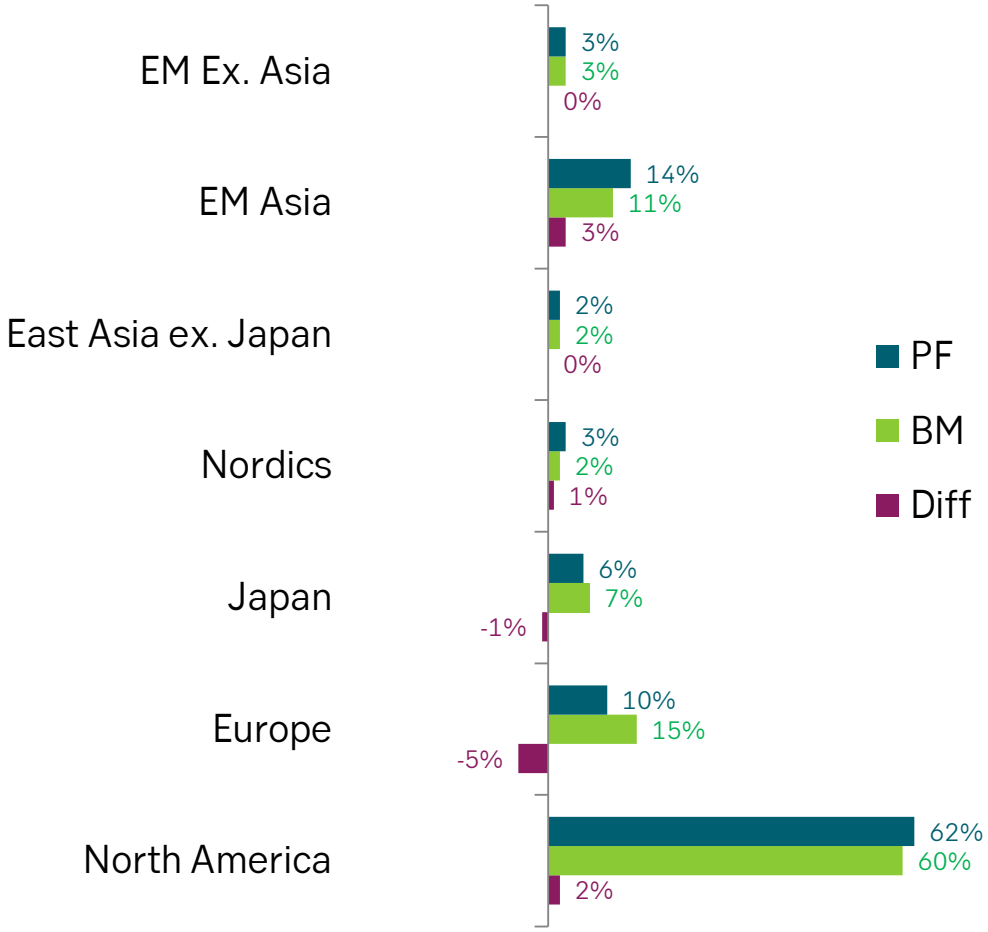
Europe is still in a tricky position, so we prefer to keep our underweight to the region

- Consumer sentiment has taken quite a hit, macro leading indicators are decreasing
- Nevertheless, it is interesting to note that large segments of the European equity market is heavily discounted
  - The region will be in a good position once the outlook stabilizes, as a lot is priced in
- In the long run the sector composition of Europe is possibly quite resilient and advantageous in an inflationary environment, but in the short-term lower global trade will weigh on the EU
- Europe is more of a value region than the US, but given the current ambiguous sentiment, it is probably too early to enter that position

Emerging markets, USD and China...

- Our overweight to EM Asia is challenged by a loss of confidence due to lockdowns
  - The determination of the policy framework in China should be supportive if policies change, but that is a big if
  - China's strategy is pro-growth as there is an ambition to increase GDP growth in 2022, however, after latest data this proves to be challenging

Regional equity positioning



Benchmark is MSCI All Country

Sector allocation

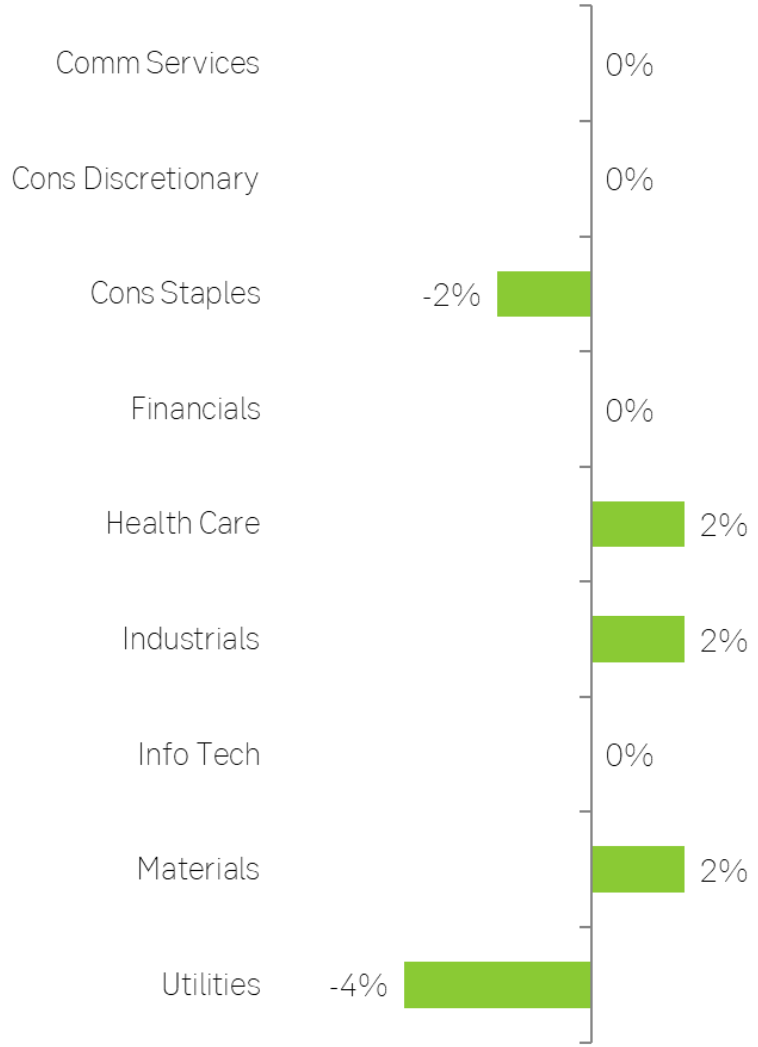
We have a slightly inflation positive position

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

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

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

Sector positioning



Risks to the investment regime

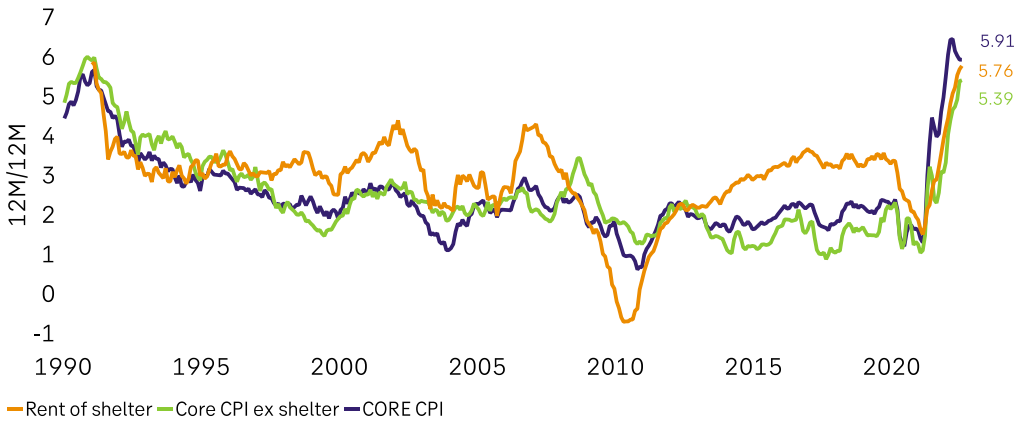
Global inflation remains elevated for longer than expected

- Global inflation remains high as food and energy prices continue to surge across the world
  - Global supply chain pressures have eased lately, but are still elevated and could increase again as China's zero-Covid policy stays in place and the war in Ukraine continues
  - Tight labor markets characterized by labor shortages and strong wage growth also contribute to the high inflation, as higher wages lead to higher prices, which in turn leads to higher wages etc.
- Given the difficult backdrop, the risk is that inflation stays high, above the 2% target, for months or even years before coming down
  - Markets have rallied on hopes for a peak in inflation and therefore also a peak in hawkishness from the Fed
    - There is a risk of disappointing US inflation data that causes a broad market correction, as the Fed decides to stay on its aggressive policy path

A severe property crash in China and European recession drag down global growth

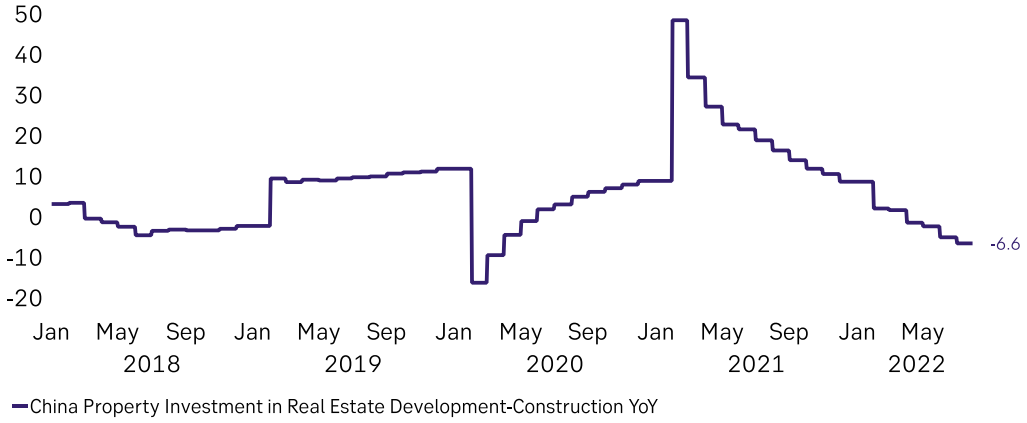
- Focus has shifted from China's zero-Covid policy to its troubled real estate market
  - The biggest risk is that the crisis in the housing market sends the Chinese economy into a recession and slows down global growth as well
    - However, a zero-Covid policy that lasts for years is also risk to growth
- A European recession would lower demand and affect global trade
  - The gas crisis in Europe could have a long duration as the war continues and it takes time to shift energy production from oil and gas towards sustainable energy

Figure 1: US core inflation, excluding volatile food and energy, remains high. Shelter CPI, which accounts for 30% of the index, is sticky and could keep inflation elevated



Source: Macrobond, SEB

Figure 2: China property investment in real estate development-construction falls YoY



Source: Macrobond, SEB

Return Estimates

Figure 1: 12 month forward looking return expectations

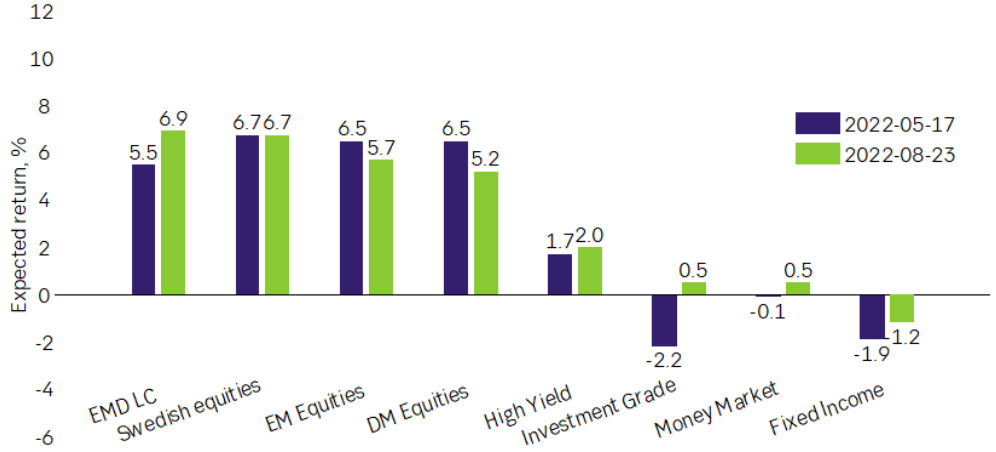


Figure 2: 12 month forward looking return expectations for equities and bonds

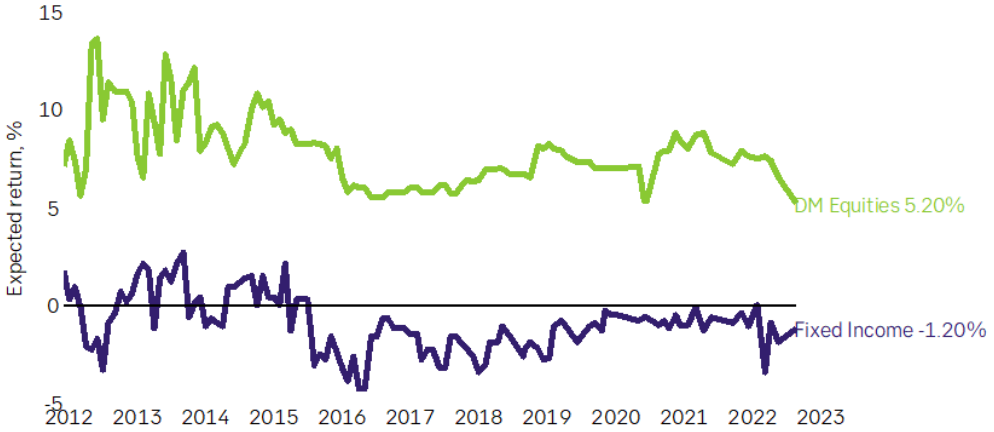


Figure 3: Absolute expected returns

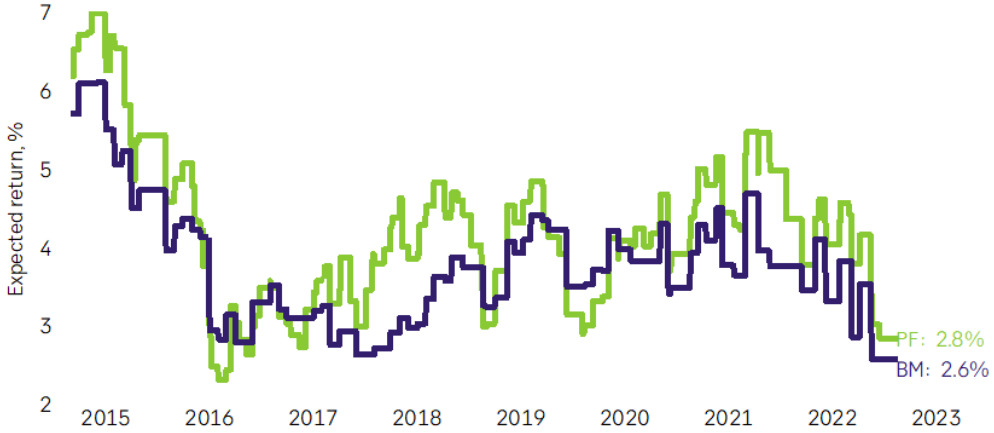
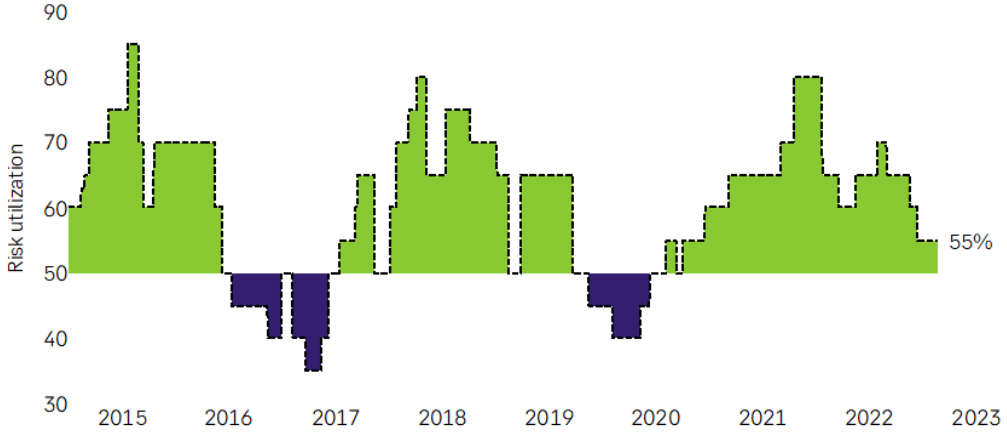


Figure 4: Risk utilization since inception



Historical House View Allocation

Figure 1: Equities

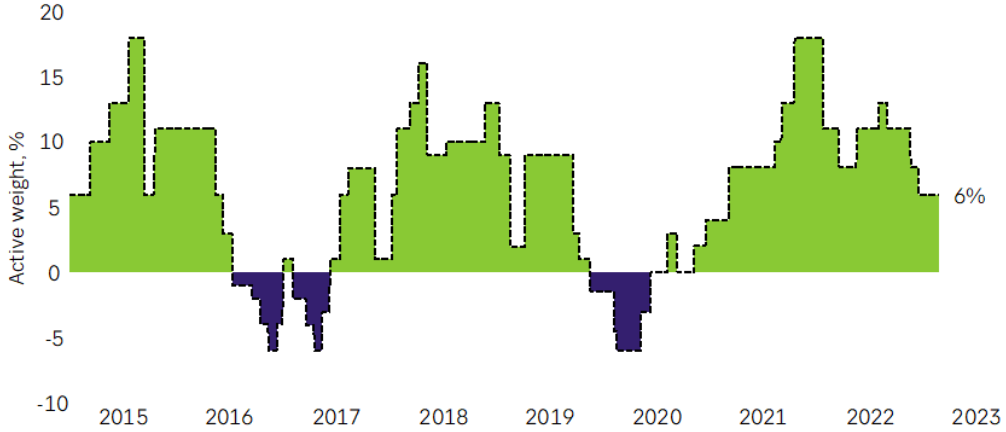


Figure 2: High Yield

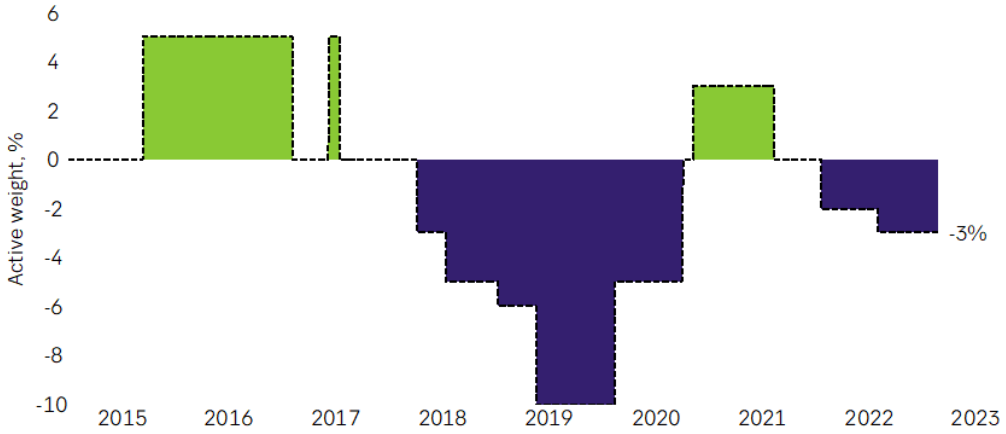


Figure 3: Emerging Market Debt

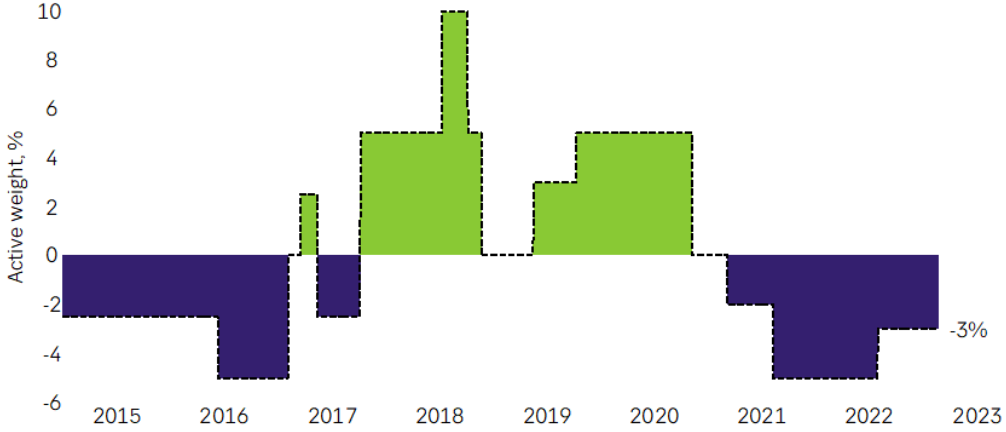
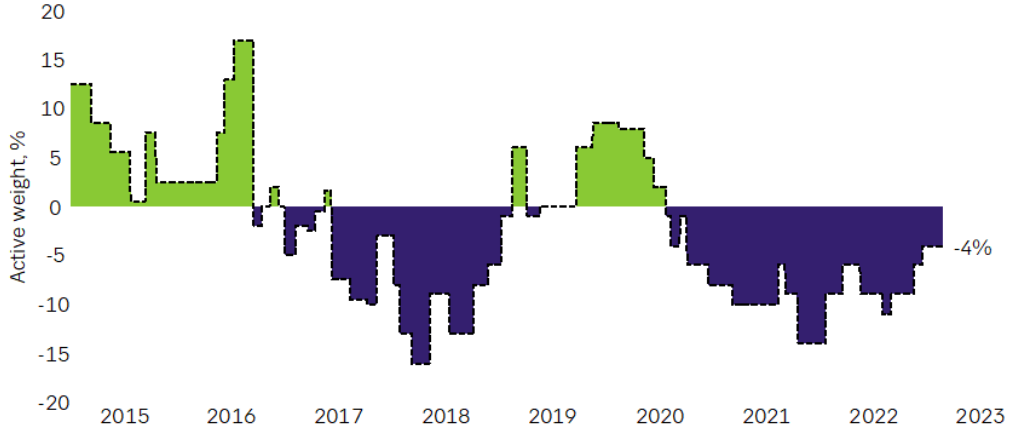


Figure 4: Fixed Income*



* 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

Macro, especially inflation, and central banks remain important as markets try to assess when inflation and Fed tightening will peak

- The Fed minutes from July's FOMC meeting did not reveal much about the pace of rate hikes going forward
  - The minutes showed that Fed will be data-dependent, which is not anything new, so markets turn their attention to macro/inflation data, which is the single most important factor

Macro data points to a global slowdown while inflation remains high and a peak in inflation has yet been confirmed

- Europe is facing headwinds from the war in Ukraine and an energy crisis after Russia decided to cut its gas exports to the region
  - Sentiment in Europe has weakened as living costs have increased due to rising food and energy price
  - Higher inflation is expected to weigh on consumption and the economic outlook
- Chinese macro data have also disappointed as covid lockdowns has lowered GDP forecasts and the real estate investments fall due to the property market crisis

Positioning have become increasingly important as there is less visibility elswhere

- Bearish investor sentiment peaked around the same time as the market rally started
- Sometimes positioning can serve as a signal for future market movements

Zero-Covid policy and the weak property market in China calls for more stimulus

- Lockdowns in China have had a larger-than-expected impact on domestic consumption and production
- Financial risks are also increasing in the Chinese economy and markets want to see more stimulus from China to boost consumption and stabilize the property market

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

- A European or global recession is the biggest tail risk right now. In Europe, we consider the gas situation and then the war as the biggest tail risk.

Figure 1: Macro and Central Banks are still the most important variables for our tactical risk taking, as markets focus on inflation and Fed hawkishness.

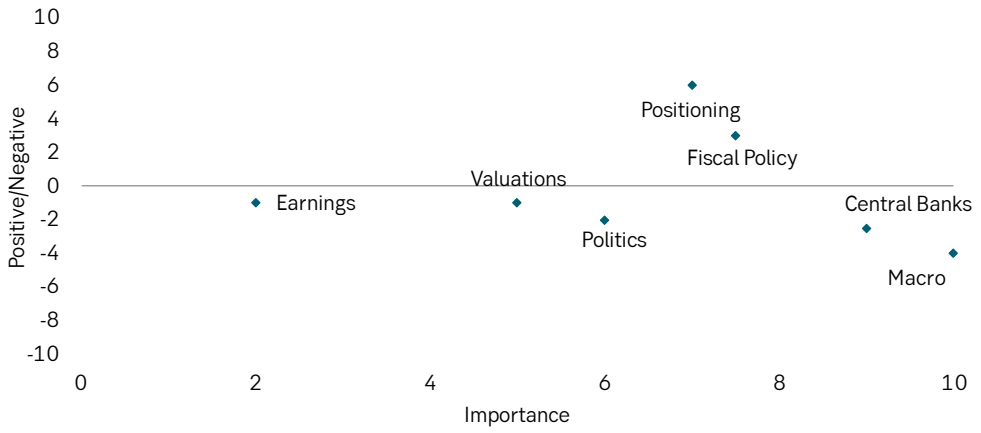
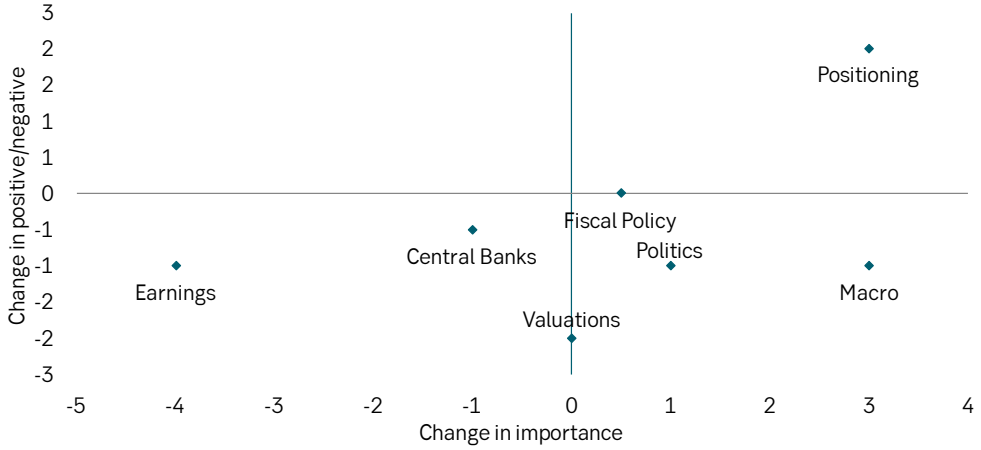


Figure 2: Macro has become more negative as confidence and growth declines. Positioning has become more positive as investors are less bearish, which have favored risky assets



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Developments in the Markets

Markets rallied on hopes for a peak in inflation and Fed hawkishness

Increased expectations for a dovish Fed policy and lower inflation expectations triggered a relief rally for stock and bond markets. Markets rose despite two 75 bps hikes by the Fed in June-July, as the hikes were discounted by markets before the FOMC meetings. Instead, dovish market interpretations of Fed Chair Powell's comments during the following press conference sent both stocks and bonds higher. Risk sentiment has also turned less bearish, which led to a stronger rebound in risky assets, while the VIX and MOVE index for stock and bond markets, respectively, have notably fallen from elevated levels. Higher interest rate volatility has been a key driver for stock market volatility this year, but has lately come down as rates have stabilized, which likely contributed to the fall in the VIX. Q2 earnings have also been solid and surprised to the upside.

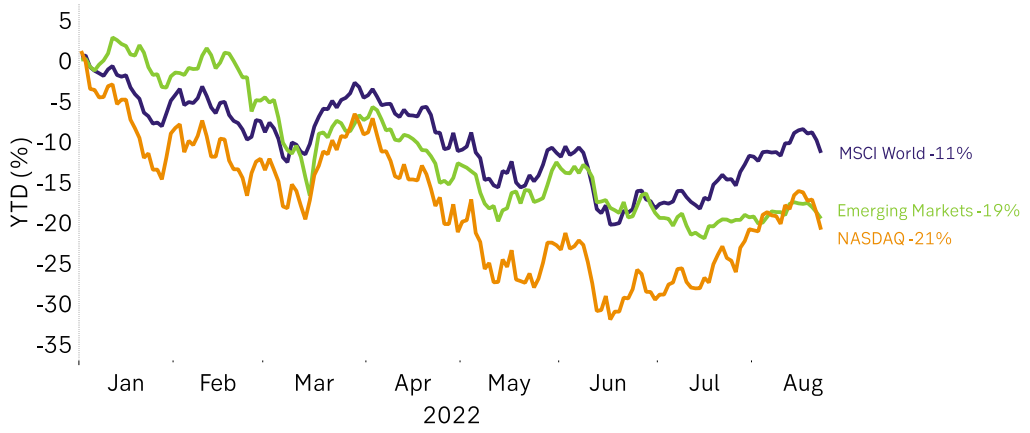
Growth style outperformed Value

Falling oil prices and signs of a slowing US labour market contributed to the decline in longer dated inflation expectations, which coincided with a change in direction of longer bond yields. The reversal in US and German 10Y government bond yields, having peaked around 3.5% and 1.8% mid-year before falling by 100bps, led to a rebound in Growth style, which has lagged Value in 1H. The 10Y-2Y yield spread in the US has also inverted, signalling a recession and lower rates ahead. The curve inversion occurred as shorter-term yields, which are more policy sensitive, climbed while longer yields stabilized.

Fed minutes from July confirmed data-dependence, but was unclear on hiking pace

The release of the minutes shows that the Fed will stay committed to raising rates as long as inflation remains high and that the pace and size of future rate hikes will depend on inflation and economic activity data, which confirms our previous view. Although FOMC participants expect that further rate hikes are needed, the statement did not give clear guidance on how fast the Fed will hike rates in the coming months. Powell did, however, leave the door open for a slower pace of rate increases "at some point" as the Fed will eventually need to evaluate the effects of its previous rate hikes on the economy. The Fed has sharply raised the upper bound for the federal funds target rate from 0.25% to 2.50% this year. Markets currently expect 5 additional hikes for the next three FOMC meetings, which puts the policy rate at 3.6% by the end of the year.

Figure 1: Global equities have risen since mid-June as markets have shrugged off over concerns about higher-for-longer inflation and an upcoming recession



Source: Macrobond, SEB

Figure 2: Stock markets have rebounded as investor sentiment improved. Historically markets have edged higher when sentiment is overly bearish

Source: Macrobond, SEB

Economy – Developed Markets

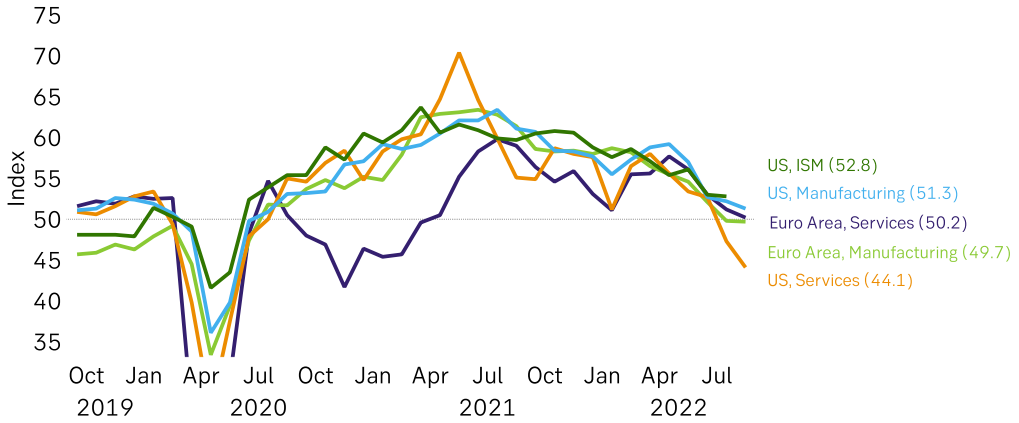
US inflation showed signs of easing in July and labor market remains strong

- US headline inflation YoY surprised to the downside and fell in July, but stayed at elevated levels, signaling that Fed may have to continue to hike rates at a fast pace
  - Headline inflation MoM fell more than consensus and was flat in July, indicating a possible peak in inflation
  - Core inflation MoM, excluding food and energy, fell from 0.7% to 0.3% in July, which was more than economists had expected
- The Fed delivered two consecutive 75 bps hikes in June and July
  - Markets interpreted Powell's July press conference as dovish, as he acknowledged the negative impact of its rate hikes on growth and signaled that the pace of rate hikes could slow in the upcoming months
  - Powell said that more financial tightening can come from previous rate hikes that have already been made, as there is a lag in monetary effects on the economy
- ISM manufacturing fell in July, but stayed in expansionary territory, while ISM services strengthened, signaling that the US service sector expanded at a faster pace
  - Consumption indicators were mixed and inputs constrained growth in production
    - Demand dropped as new orders fell and customer inventories remained low
    - Production kept growing, but at a slower pace and employment contracted
    - Supplier deliveries improved and prices rose at a slower pace
- US consumption was solid in July, as retail sales rose YoY and sales ex auto rose MoM
  - Consumer sentiment also increased according to the Michigan survey
- The labor market remains tight, as it added 528k jobs and unemployment fell to 3.5%
  - However, hourly wages rose more than consensus, fueling inflation pressures

Russian gas cutoff weigh on sentiment, ECB is expected to raise rates

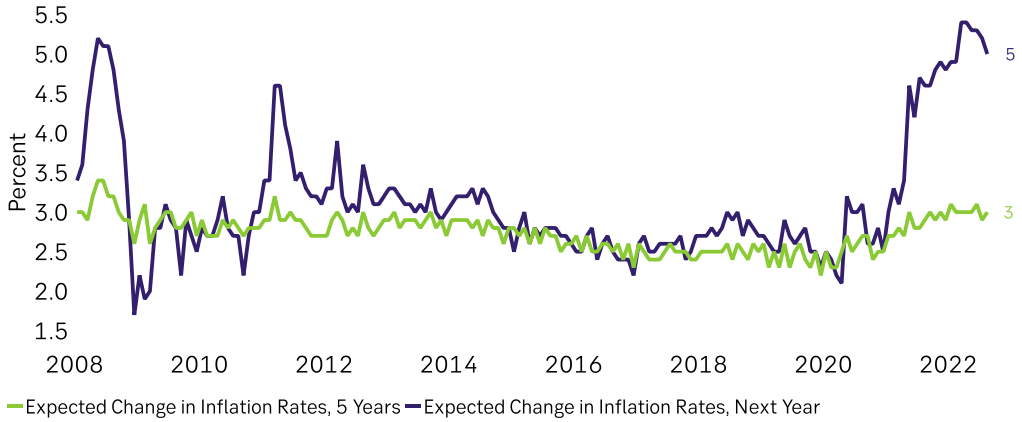
- Eurozone sentiment has sharply declined over the threat of a Russian gas cutoff
  - German Gfk consumer sentiment dropped to a record low as the war in Ukraine push up already high prices for food and energy
- The ECB is expected to raise rates by another 0.50% in September, its second big rate hike, despite the higher recession risks due to the energy crisis in the region

Figure 1: PMI:s trend downwards in the US and Euro area, as global growth slows. ISM Manufacturing is above 50, which signals an expansion in the US economy.



Source: Macrobond, SEB

Figure 2: US consumers expect inflation to remain elevated next year and prices to rise at an annual pace of 3% over the next 5 years



Source: Macrobond, SEB

Economy – Emerging Markets

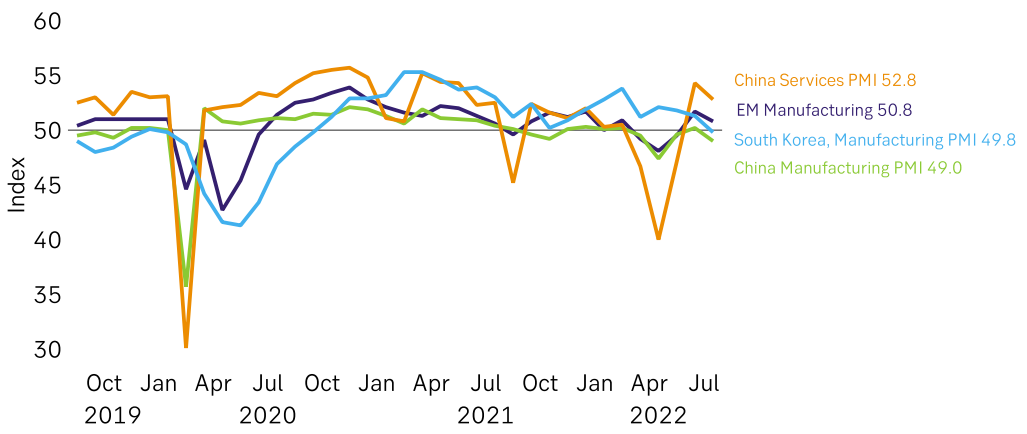
The global energy crisis and stronger USD challenge Emerging Markets

- The war in Ukraine has pushed up energy prices and tightened supply everywhere
  - Higher natural gas prices have led to blackouts and austerity measures in poorer developing countries, as they have found it difficult to compete with richer countries over energy supplies at these levels
    - Emerging economies are more dependent on coal and gas, which they cannot secure right now, and that has forced companies to reduce their production
  - A stronger USD has also increased the import cost of natural gas for developing countries, which contributes further to the high inflation

China's Premier Li calls for more stimulus to support weakening economy

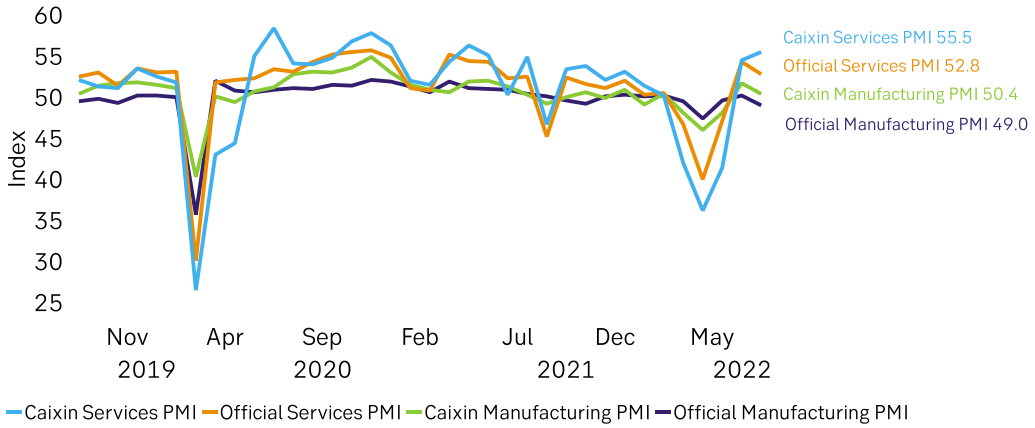
- The announcement came as activity data in July missed forecasts, signaling a slowdown in the Chinese economy after the short covid-rebound in June
  - Growth in retail sales and industrial production fell below expectations due to negative impact from covid lockdowns and a weaker real estate market
  - The premier called for more stimulus while stressing the need for striking a balance between growth and covid controls in a meeting with local officials
  - Li's pro-growth rhetoric contrasts with July's Politburo meeting, which signaled limited stimulus and no change in the country's strict zero-Covid policy
- Official manufacturing PMI fell below 50 in July, indicating a contraction in the sector
  - Energy-intensive industries like petrol and coking coal contributed most to the fall
  - Output and new orders fell amid covid restrictions and weaker global demand
  - In contrast, Caixin manufacturing PMI fell more than expected , but remained above 50 in July, showing that manufacturing activity expanded at a slower pace
- The service sector fared better than manufacturing in July as both official and Caixin service PMIs pointed to an expansion in the sector
  - Caixin PMI marked the fastest pace of expansion in services since April 2021, on the back of improved domestic demand and confidence from eased covid curbs
  - The official survey showed moderating growth, but also pointed to higher activity
- China also faces headwinds from a downturn in the real estate market, which has increased financial risks and led to vows from leaders to stabilize the property sector

Figure 1: EM indicators for manufacturing have started to fall amid high energy costs



Source: Macrobond, SEB

Figure 2: Official and Caixin manufacturing PMIs were mixed in July, but both surveys showed that service sectors continued to expanded for a second month in a row



Source: Macrobond, SEB

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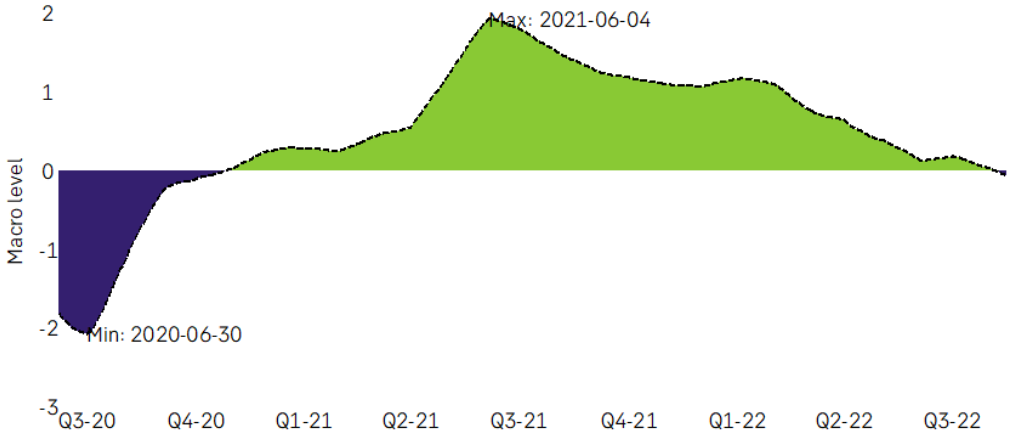
SEB House View – US Macro Status

US macro is almost neutral, but could surprise to the upside as expectations are lower

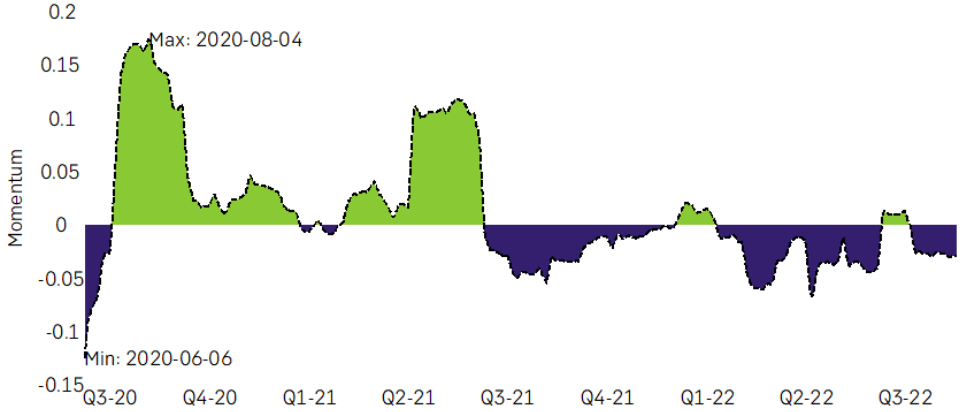
- July's headline and core inflation, excluding volatile items, surprised to the downside
  - Headline inflation fell to 8.5% from 9.1%, beating the consensus forecast of 8.7%
  - On a monthly basis, inflation was 0% for the first time in 25 months as prices for gas, apparel and airline tickets fell, signaling a potential peak in inflation
- ISM manufacturing fell less-than-expected in July and stayed in expansionary territory
  - Demand was decent as export orders grew and new orders only fell slightly
  - Customer inventory was low but is approaching 40 percent
  - Consumption were mixed: production grew at a slower pace while employment contracted as companies faced labor shortages
  - Inputs constrained production to a less extent due to improving supplier deliveries and prices paid increasing at a slower rate because of lower commodity prices
  - ISM for services increased further above 50, pointing to a more rapid expansion

Figure 1: The US macro level is now barely negative, just below its 5-year average



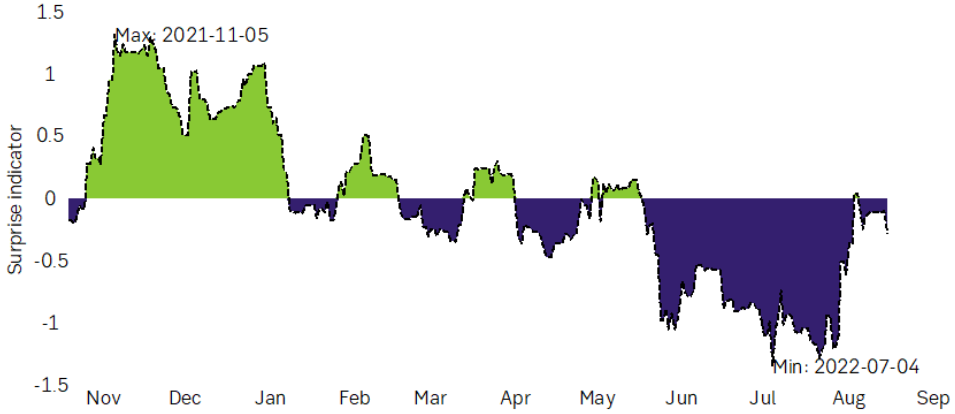
Source: SEB House View

Figure 2: Macro momentum has been negative due to a decline in ISM manufacturing, mostly new orders, and the sharp contraction in Philly Fed



Source: SEB House View

Figure 3: Macro has surprised to the downside due to low housing starts and weak Philly Fed. However, we could see positive surprises going forward as expectations are lower



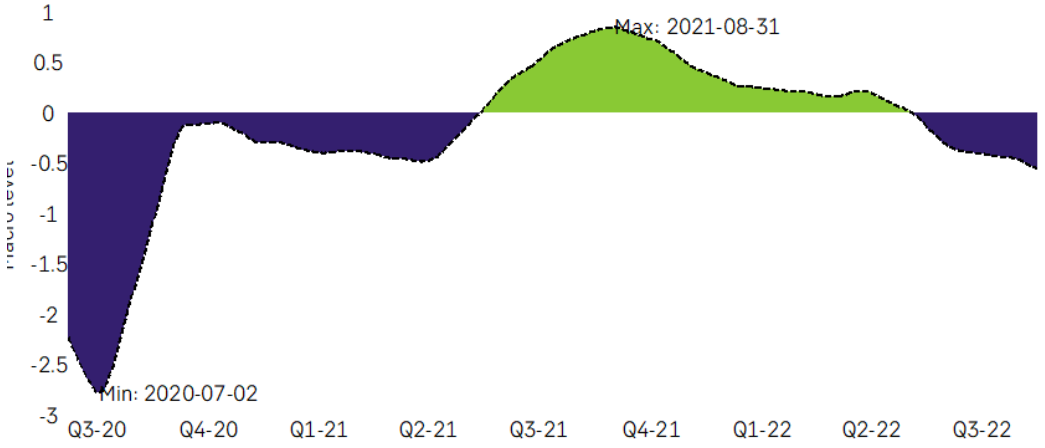
Source: SEB House View

SEB House View – EU Macro Status

Overall sentiment in Europe is weak due to growing fears over a Russian gas cut

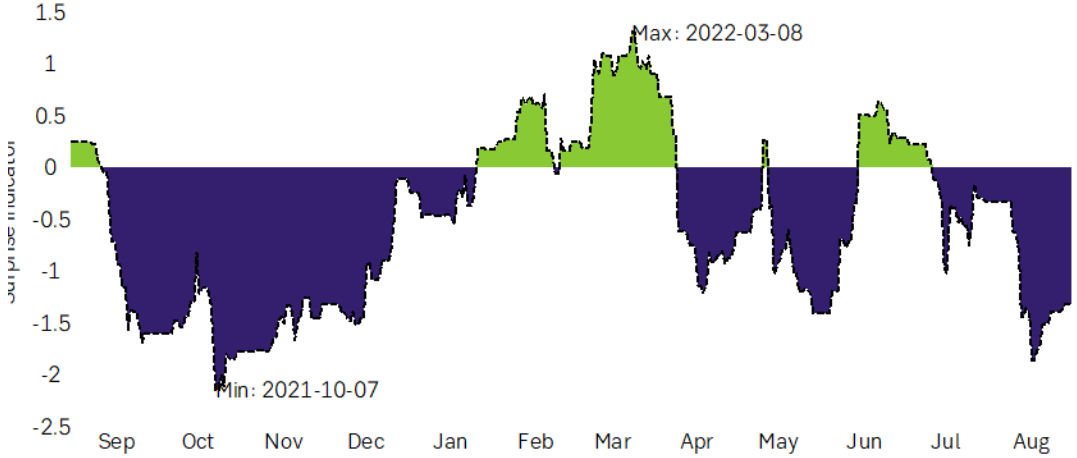
- Eurozone inflation rose to 8.9% in July, a new all-time high, due to higher food and energy prices from the war in Ukraine and gas crisis in Europe
- German confidence has been hit particularly hard over energy supply concerns
  - Ifo business expectations in Germany, Europe's largest importer of Russian gas, fell after Russia reduced its gas exports in response to Western sanctions
- Europe's outlook has worsened, as inflation weigh spending power and growth
- The ECB is likely to hike rates by 50 bps in September, despite the weaker outlook
  - The ECB lag other central banks in monetary tightening while inflation pressures have built up, for which it will need to compensate by making a larger move in rates
  - Higher rates and tighter financial conditions further adds to recession risks
- Composite PMI fell to 49.9 in July, pointing to a shrinking European economy
  - Manufacturing activity contracted due to a drop in demand and business confidence
  - The service sector grew at its slowest pace as the boost from lifted covid restrictions wore off and the intake of new business fell

Figure 1: European macro level is negative due to very weak sentiment



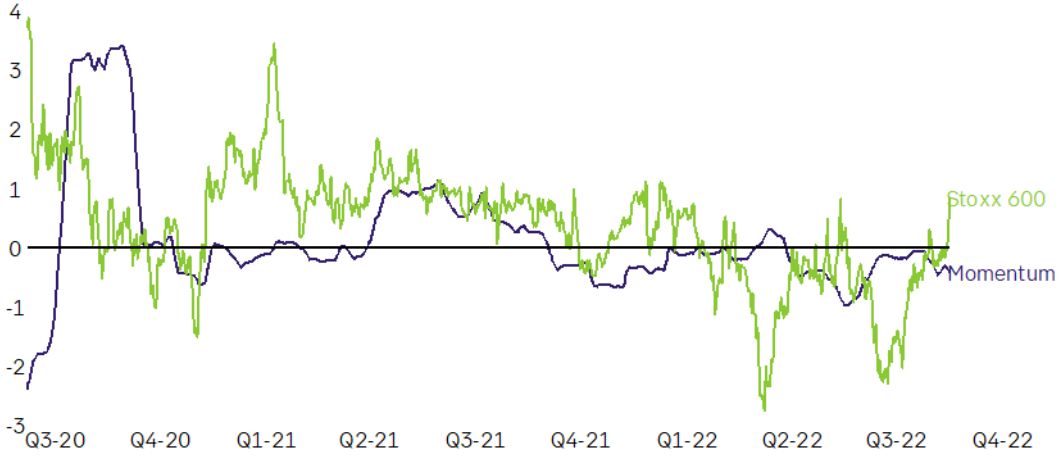
Source: SEB House View

Figure 2: EU consumer confidence and Ifo business confidence have disappointed



Source: SEB House View

Figure 3:Stoxx 600 have soared despite negative momentum in EU macro data



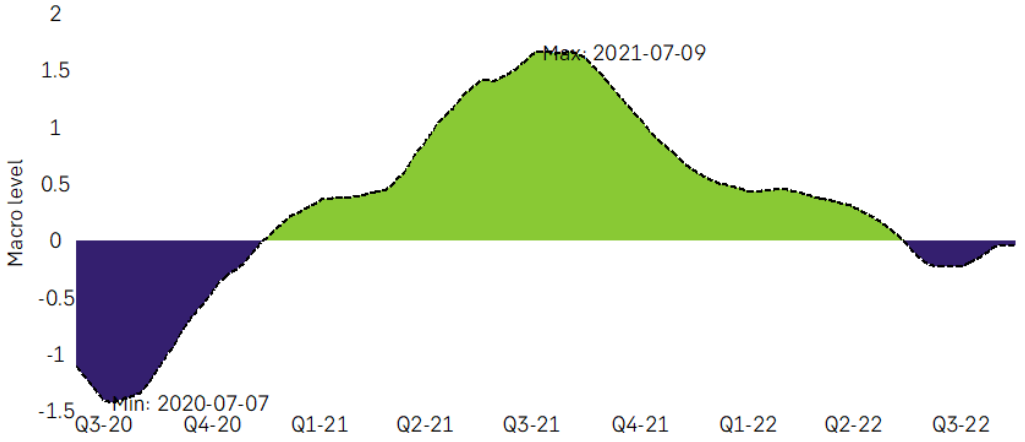
Source: SEB House View

SEB House View – EM Macro Status

Economic activity in Asia fall due to lower global demand and drop in China output

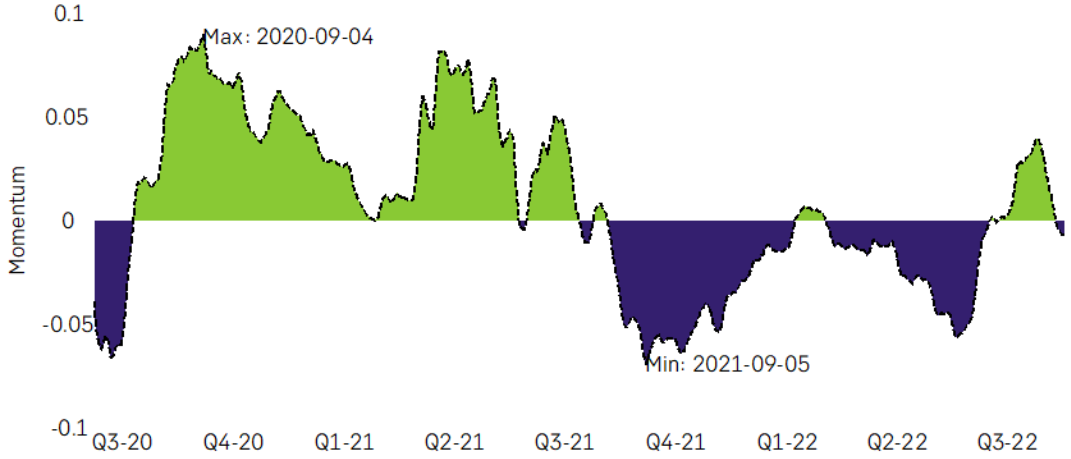
- China's factory output unexpectedly slipped into a contraction in July, amid a new surge in covid cases
  - China's zero-Covid policy, which impose new restrictions whenever new cases emerge, interrupts the country's economic recovery and threatens the stability of global supply chains
- The weaker property market characterized by falling prices and cancelled mortgage payments, is an even bigger potential problem for growth than lockdowns
  - The housing market is a large part of the Chinese economy, the second largest in the world, and a sharp decline in house prices would also affect the global economy
  - China is expected to prevent a full-scale crash by bailing out distressed developers
- Chinese retail in July sales came in at 2.7%, far below the consensus of 4.9%
  - Premier Li calls for fiscal stimulus to support falling production and consumption
  - Looser monetary policy is possible as the PBOC's modest rate cut did not ease fears

Figure 1: The EM macro level has remained negative due to new lockdowns in China



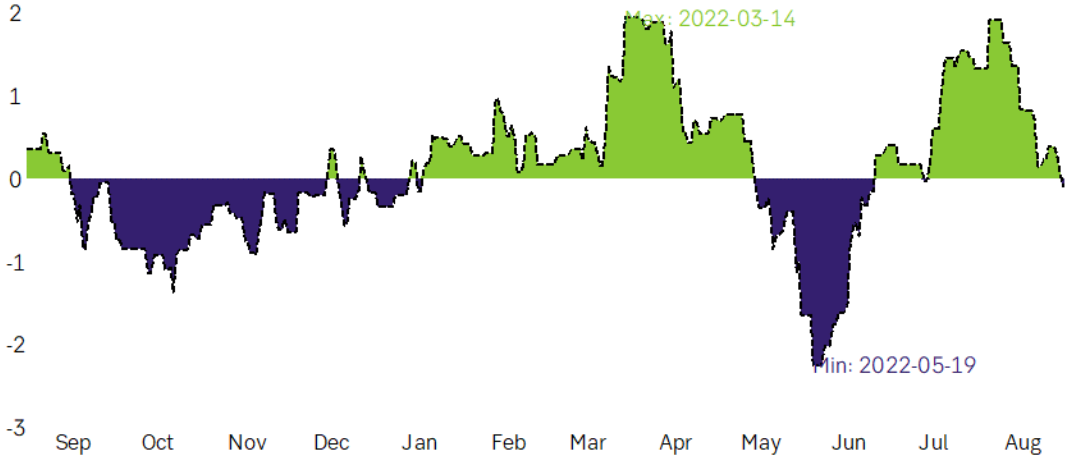
Source: SEB House View

Figure 2: Momentum turned negative again after Taiwan PMI and HK retail sales fell



Source: SEB House View

Figure 3: HK retail sales and exports contributed negatively to disappointing EM macro



Source: SEB House View

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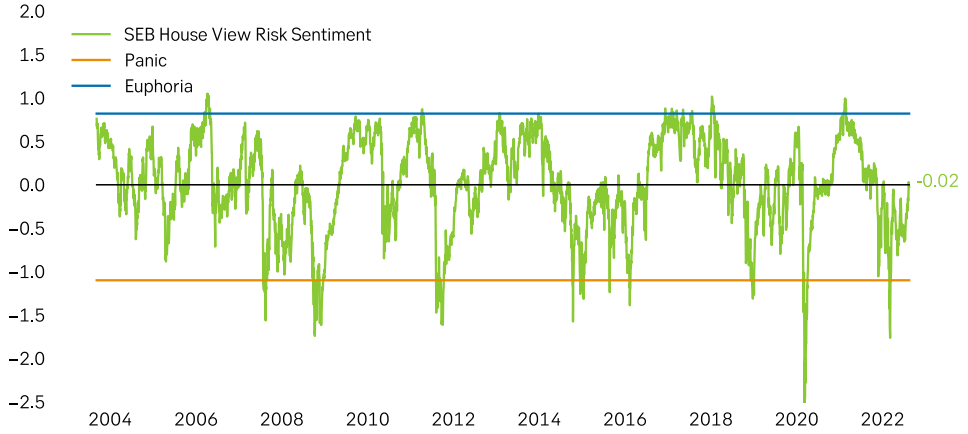
SEB House View – Risk Indicator

Our Risk Indicator approaches neutral as investors turn more bullish

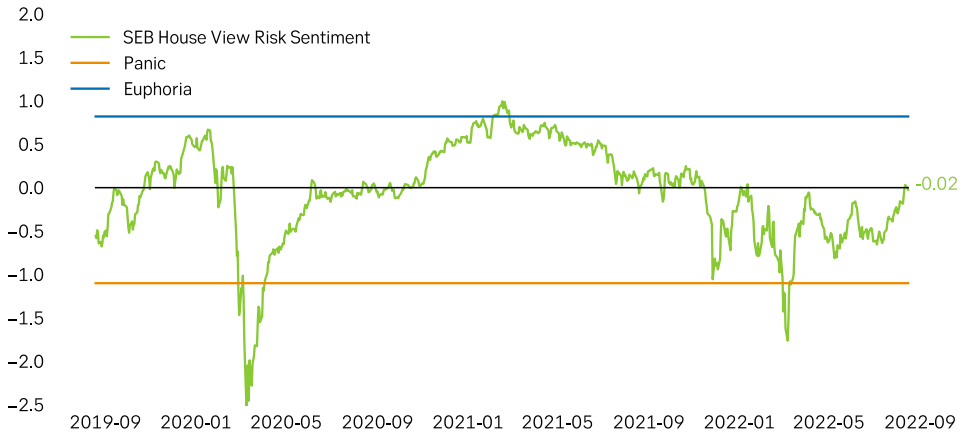
- Our Risk Indicator has recovered from negative territory after the recent market rally and now signals a neutral level of risk sentiment
  - Risk sentiment had previously fallen on the back of inflation worries and recession fears, which caused markets to enter a bear market in June
  - Our indicator subsequently increased after a surge in both stock and bond markets, following Powell's dovish comments at the July FOMC meeting
    - Stabilizing long yields and falling market volatility contributed positively
  - However, Fed minutes from July revealed that the central bank is determined to curb inflation despite a weakening economy, which saw global markets slide
  - Risk sentiment seems healthy for now, but we will closely monitor the development as the situation can change quickly:
    - Investors focus on Fed hikes, Europe's energy crisis, weakness in China and US-China relations over Taiwan

Figure 1: SEB House View Risk Indicator



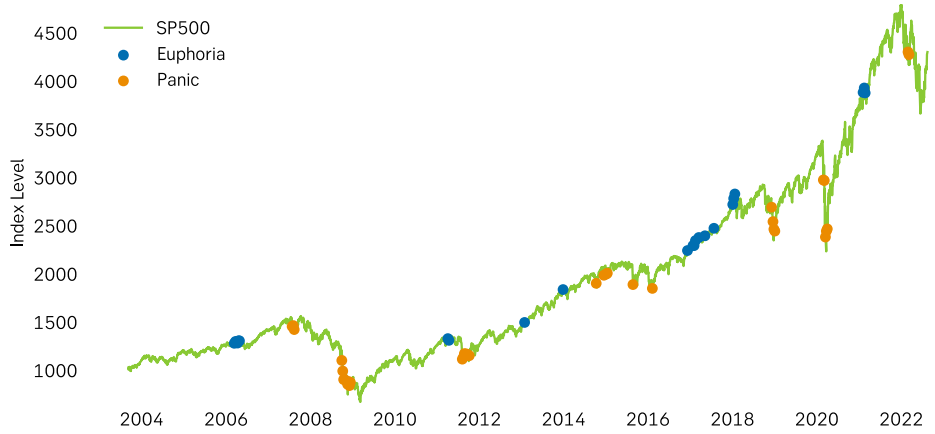
Source: SEB House View

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



Source: SEB House View

Figure 3: Extreme states plotted on SP500



Source: SEB House View

In Focus: US inflation

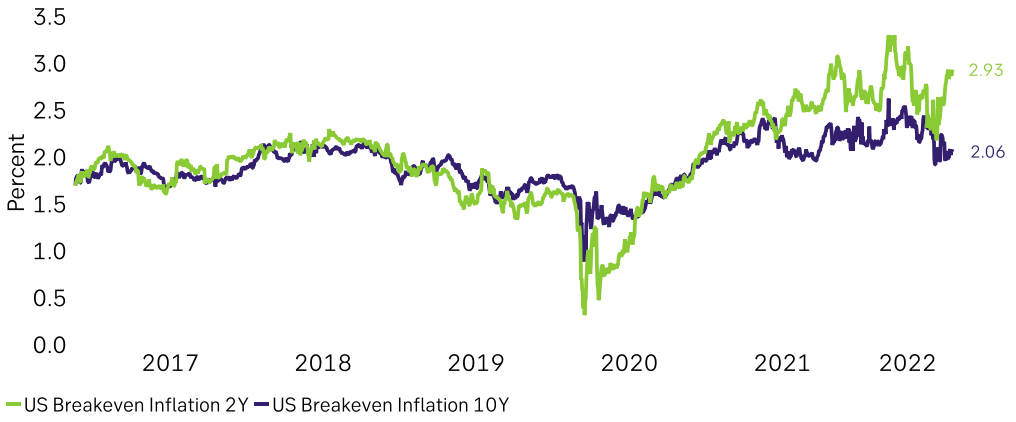
Minutes show that Fed will target inflation, but not when the pace of hikes will ease

- The big question is if US inflation has peaked and how fast it will come down in the coming months
  - Markets rallied after the Fed hiked rates in July, after dovish signals from the central bank during the press conference that lowered interest rates expectations
  - However, the minutes from the FOMC meeting has confirmed that the Fed will be data dependent and continue to raise rats until data shows signs of easing inflation
  - Inflation would need to fall and Fed pivot from its path for a sustained bull rally
  - The biggest risks are sluggish inflation and continued fast pace of rate hikes

Improvements in inflation indicators partially justify the relief rally, but some obstacles remain before it looks like inflation pressures can come down

- We have looked at several inflation indicators that compare current and historical levels against their 10-year averages to give us a better overview of broader inflation pressures, where inflation is now and likely to head next
  - The more standard deviations an indicator is above the mean, the darker blue color is in the heat map. The columns correspond to the current and last 12 months, starting from the rightmost column. The current month column mostly includes data from July and the latest PCE print from June, due to a lag in data releases
- Inflationary pressures in commodity markets and business and consumer sentiment surveys have fallen, amid a moderation in commodity prices, especially ex-energy
  - Sentiment could give a hint of the inflation path forward as it was a leading indicator last year when pressures started to built up
- Wages are higher now than in 2021 and have continued to climb throughout the year, in contrast with other indicators, and therefore still pose an upward risk to inflation
- Inflation components, including five measures of CPI for shelter, college, car rentals, recreation and drugs, have had the biggest lag among indicators in 2021-2022
  - Shelter inflation, which makes up a third of CPI inflation, has increased steadily and is currently more than four standard deviations above its mean
  - Sticky shelter inflation could prevent headline inflation from falling back to the Fed's 2% target quickly.

Figure 1: US inflation expectations have come down or stabilized, but we will only know for sure that inflation has peaked once several indicators show less pressure



Source: Macrobond, SEB

Figure 2: A heatmap of different inflation indicators indicate lower price pressures from commodity markets, such as energy and agriculture, and sentiment

Economic	3,64	3,75	4,32	4,48	4,38	4,40	4,31	4,16	3,75	3,57	3,54	n/a	3,54
Inflation components	0,01	0,23	0,47	0,38	0,61	1,21	1,34	1,32	1,09	1,15	1,20	1,22	1,22
Market indicators	0,60	0,81	0,99	0,83	0,93	0,83	1,06	1,40	1,61	0,97	0,47	0,72	0,72
Sentiment	2,98	2,82	3,22	3,27	2,64	2,58	2,61	3,29	2,99	2,66	2,66	1,99	1,99
Commodities	1,67	2,01	2,07	1,47	1,39	1,41	1,32	1,64	1,23	0,96	0,43	0,37	0,37
Wages	1,38	1,61	1,71	1,58	1,78	2,01	2,07	2,15	2,08	2,25	2,33	2,26	2,26
Forecasts	0,81	0,75	0,73	0,70	0,70	2,07	2,37	3,05	3,15	3,03	2,98	2,90	2,90

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Developed Market Equities – 12M Outlook

Our 12 month outlook for developed market equities remains uncertain due to elevated inflation and a global slowdown, but we still expect that equities can outperform government bonds in the late cycle

Weaker macro data in developed economies point to a slowdown in growth. Elevated inflation pressures and rising interest rates have started to take a toll on consumer spending. The recent US 10y-2y yield curve inversion signals a US recession ahead. There have been growing concerns for whether the Fed can manage a soft landing, since the central bank has signaled more hikes to bring down the elevated inflation pressures. Having said that, we expect that the US economy will grow in 2022, supported by a strong labor market and resilient consumption. Better consumption should lower the likelihood of the US currently being in an actual recession, despite recent GDP cuts which pushed the US into a technical recession in the last quarter.

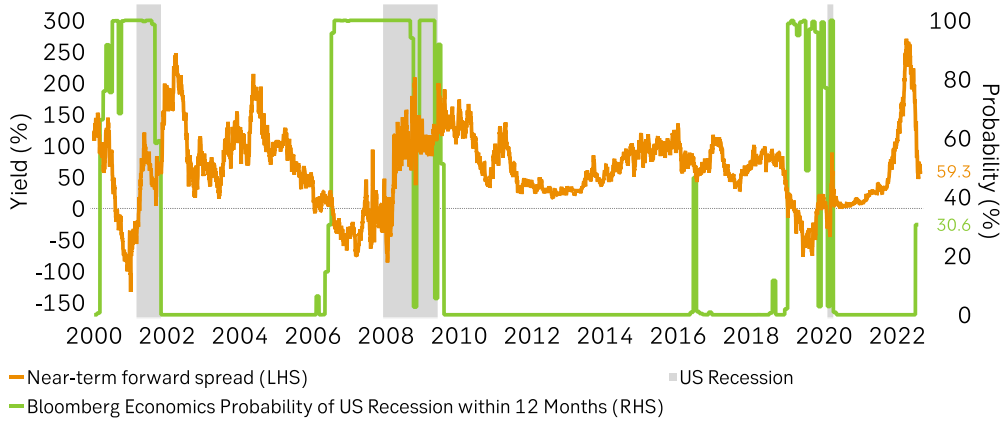
Equities could outperform bonds even if inflation remains high after a peak

In the near-term, we believe that a peak in inflation is more likely than rising inflation. Historically, equities have outperformed bonds in the next 1-12 months after an inflation peak, if a recession did not follow, that is if growth is good enough. We also believe that equities will outperform bonds since we expect the economy to continue to expand, albeit at a slower pace, and inflation to fall.

Companies that can offer growth and raise prices will be winners in the slowdown

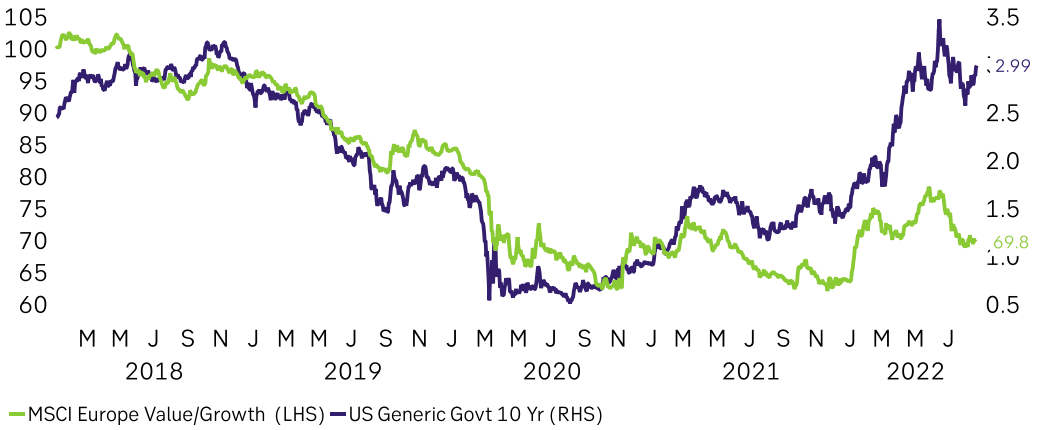
Although inflation may have peaked in July, higher-for-longer inflation is still a downside risk. Therefore, companies with pricing power should outperform in 2022. Second-quarter earnings surprised to the upside, which can give equities short-term momentum. However, as economic growth slows, investors will be willing to pay more for companies that offers better earnings growth. Until we see an increase in longer-dated yields or a steeper yield curve, growth stocks will likely continue to outperform value stocks.

Figure 1: The probability of a US recession in the next 12 months has increased, but the risk of an imminent recession is low as the labor market and consumption remain strong



Source: Macrobond, SEB

Figure 2: Growth could continue to outperform value as longer yields remain stable



Source: Macrobond, SEB

Emerging Market Equities – 12M Outlook

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

The growth premium of EM markets relative to DM markets can accelerate in 2022 as inflation and commodity prices will likely remain elevated in this new evolving phase. That is, we could see an improvement of GDP in these regions and can expect further positive earnings revisions. The reopening trade is yet not fully priced in for the region and should benefit EM. However, a downturn in the real estate market and covid lockdowns in China are still major risks for the region. Leaders at July's Politburo reiterated their vows to stabilize the property market, but also signaled that China will stick to its zero-Covid policy. Nevertheless, China is still expected to grow around an impressive 4 % this year, down from its previous 5.5% goal. In our view, as long as the global economic outlook remains buoyant, we expect EM equities 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 policy, following Premier Li's recent call for pro-growth policies. As inflation is still below the 3% target, the PBOC is at a different starting point than DM central banks and can support the economy with stimulating monetary and fiscal policies.

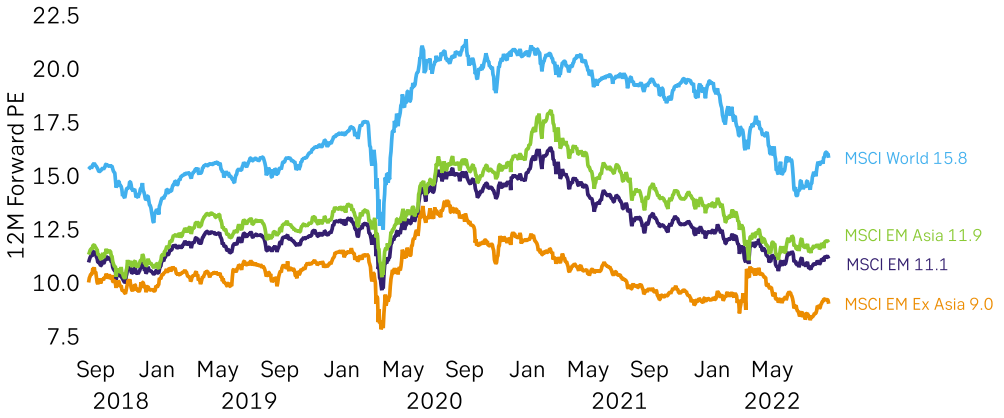
The direction of the dollar will determine the performance of EM equities

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

Price levels in EM equities remain attractive relative to DM equities

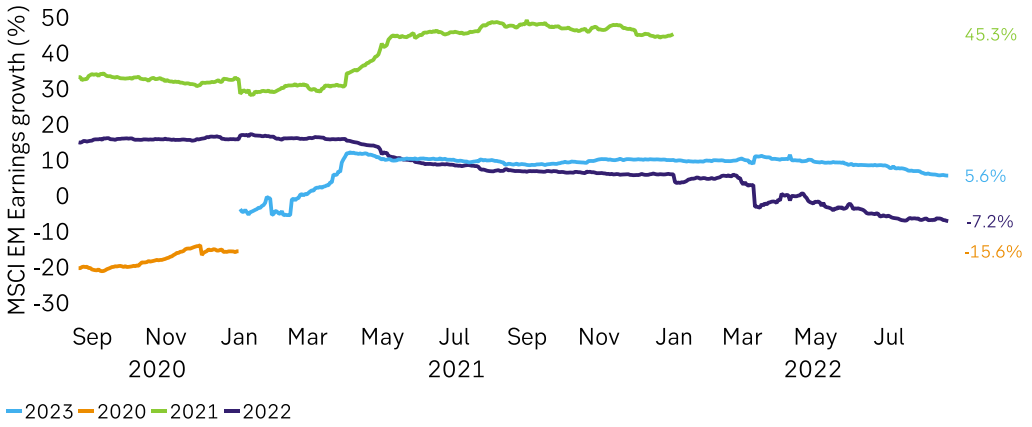
EM valuation has traded cheaper due to a multitude of challenges last year: zero Covid strategy, property sector adjustment, power rationing and a regulatory adjustment to the corporate profit share. Global investors are still relatively underweight EM due to the higher risk premia in the region, but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

Figure 1: Emerging market equities can now come into favor as the region is expected to grow at a faster pace than developed countries, amid a global slowdown



Source: Macrobond, SEB

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



Source: Macrobond, SEB

Corporate Bonds – 12M Outlook

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

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

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

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

We expect credit profiles to remain stable as activity normalizes

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

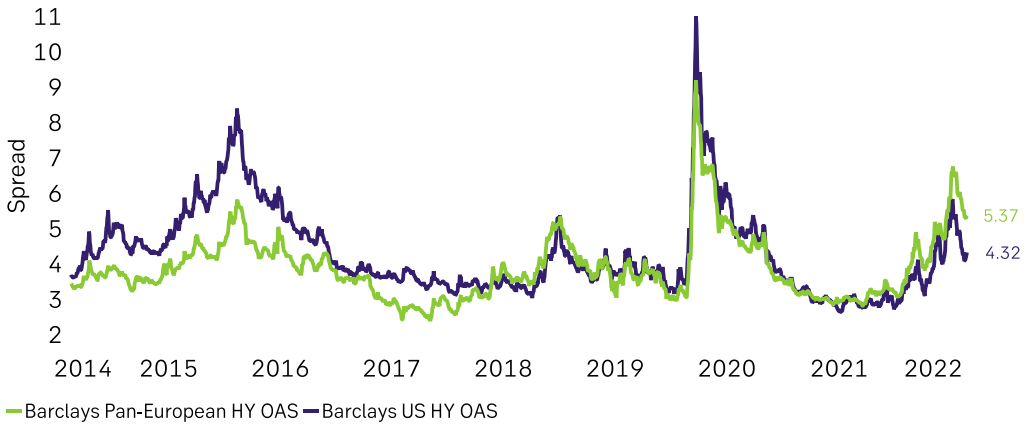
Liquidity in the market is getting more challenged

Recently financial conditions have slightly eased due to hopes of a peak in US inflation and a Fed pivot. Nevertheless, we expect financial conditions to deteriorate as we see tighter monetary policy from global central banks. The US Treasury curve has inverted as bond markets have a more negative outlook. And with a tightening monetary policy ahead we could see further volatility in bond markets onwards.

Nevertheless, we expect default rates to stay low moving forward

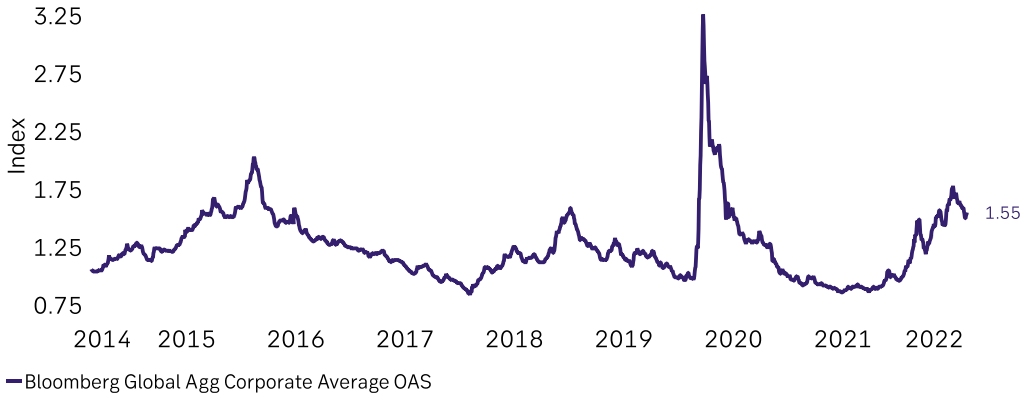
We expect it is unlikely that default risks will be priced aggressively as businesses have strong balance sheets and systemic defaults are less likely. However, we note that with elevated inflation the downside risks have increased

Figure 1: HY spreads in the US and Europe tightened during the relief rally. In our view, risks of wider spreads remain, due to Europe's energy crisis and the tense situation in Taiwan



Source: Macrobond, SEB

Figure 2: The spread on Investment Grade bonds also tightened as the corporate bond market rallied and bond yields fell. However, spreads are still at elevated levels.



Source: Macrobond, SEB

Government Bonds – 12M Outlook

We hold an underweight to Government Bonds in favor of Equities

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

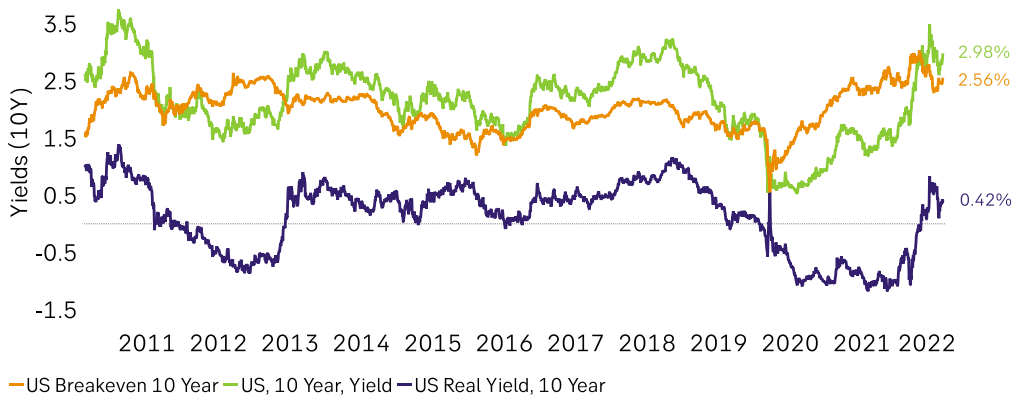
Real yields have turned positive due to the rapid rise in yields

The US yield curve inverted last month as markets became increasingly concerned about the Fed's ability to achieve a soft landing amid rapid tightening of monetary policy. Markets currently discount nearly 5 Fed hikes for 2022. Inflation breakevens have moved downwards as central banks are now focused on battling inflation, but also because markets are more worried about the economic outlook. Given these moves, we have seen real yields rise and close in on positive levels. A rise in real yields should be beneficial for markets. But while a gradual rise in real yields reflects the fact that the economy is improving, a fast rise in real yields may spark volatility for equity investors. However, real yields are still at low levels which will likely keep a lid on the potential return for government bonds.

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

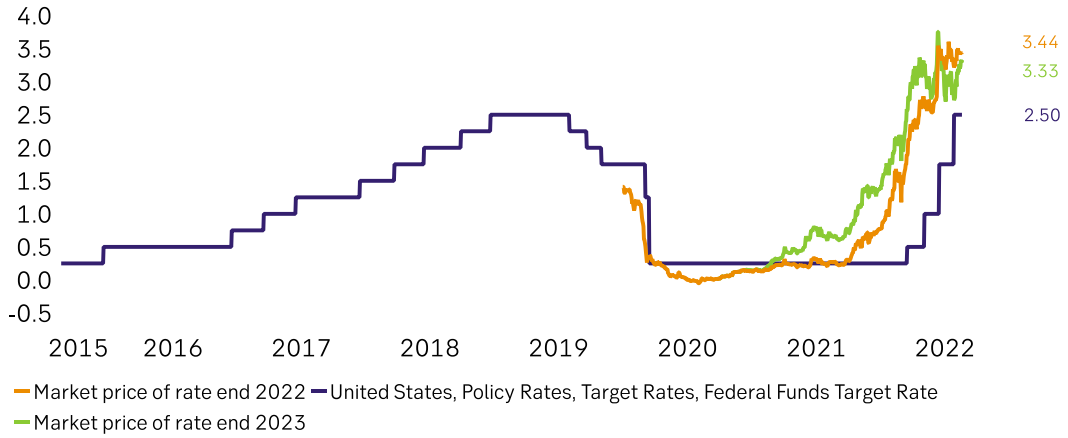
The enormous monetary and fiscal stimulus has allowed for central banks and governments balance sheets to balloon. Therefore, in order to fund the current national debt levels governments are likely to maintain interest rates at low levels for a very long time.

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



Source: Macrobond, SEB

Figure 2: The Fed hiked rates by 75 bps in both June and July, but markets are pricing in more hikes to obtain a year end rate that we have not seen since 2008



Source: Macrobond, SEB

Region Overview

Regional equity positioning

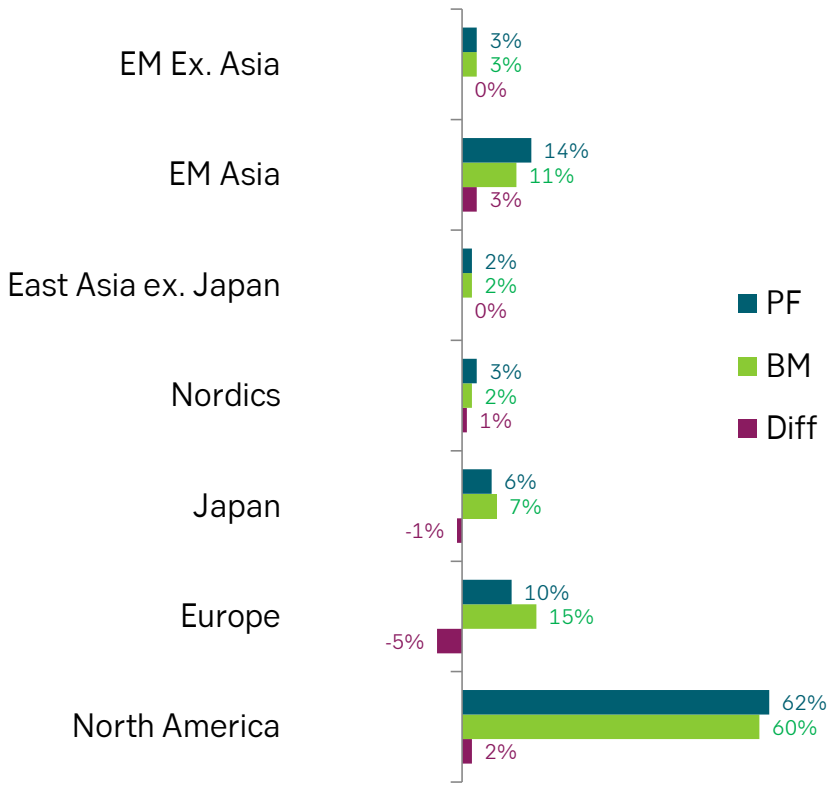
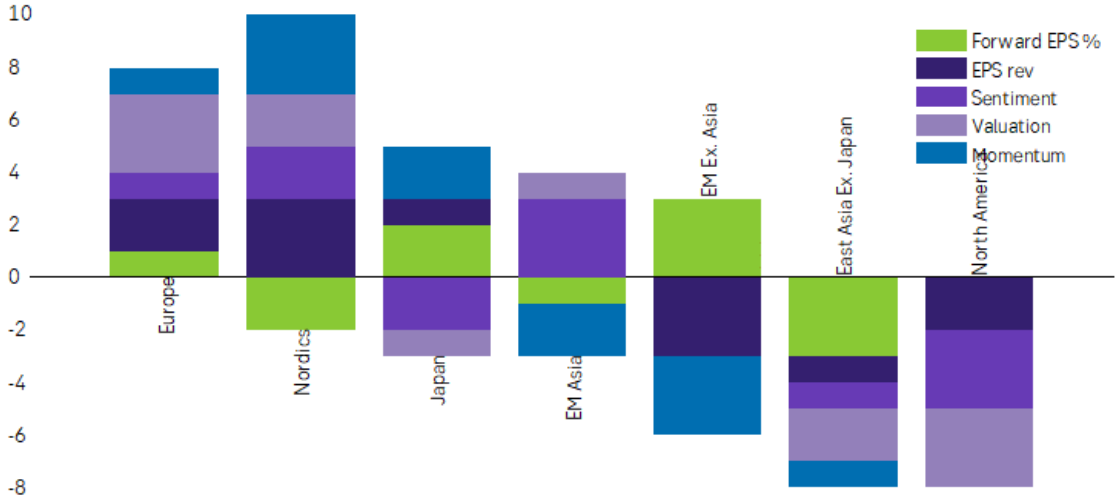


Figure 1: SEB House View region score*



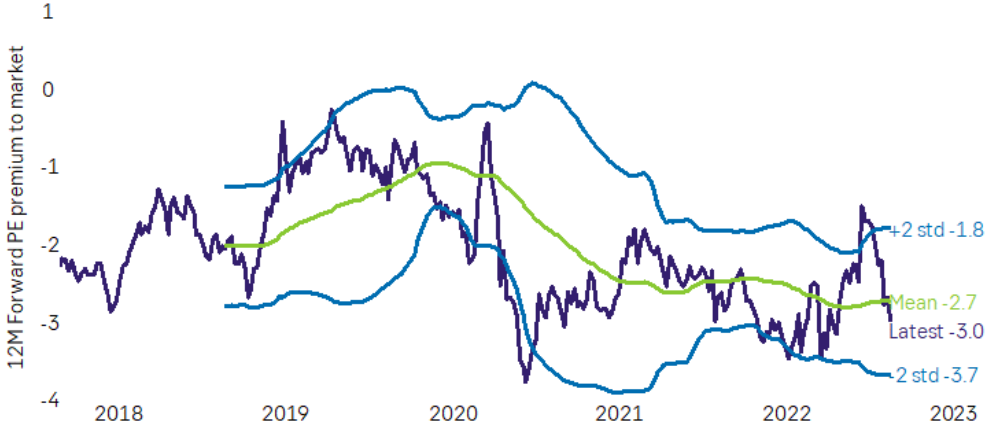
* Ranked by total score with highest score starting from left

EM Asia – Overweight

Policy support from China is more likely after weaker demand and property risks

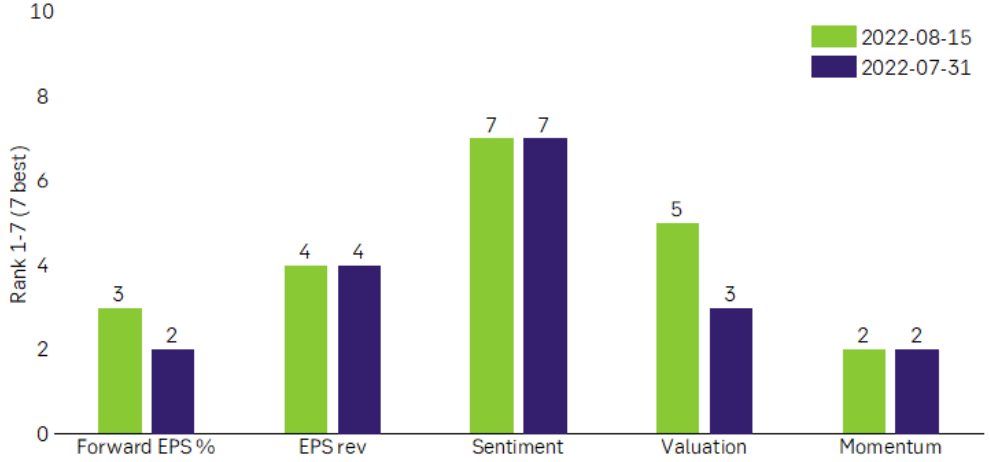
- Chinese macro has disappointed in July, both on the production and demand side
  - However, surveys for manufacturing activity sent mixed signals
    - The official manufacturing PMI showed a contraction in the sector due to covid lockdowns, while Caixin manufacturing PMI instead pointed to a deacceleration
  - Retail sales grew slower-than-expected YoY as domestic demand weakened
- According to FMS, the biggest tail risk now is a credit event in China's property market
  - China's crackdown on property developers, including tightened funding, is part of its long-term strategy to maintain financial stability
  - Nevertheless, credit defaults among developers have spiked as a result and China will likely pursue pro-growth polices and provide liquidity to stabilize the economy
- China's relatively low inflation compared with other regions is also an advantage, as it allows the country to ease policy and cut rates to stimulate the economy
  - Lower rates should support valuations of Asian stocks, which already look underbought according to our Region Model, and thus provide attractive returns

Figure 1: Standardized relative valuation – Current constituents



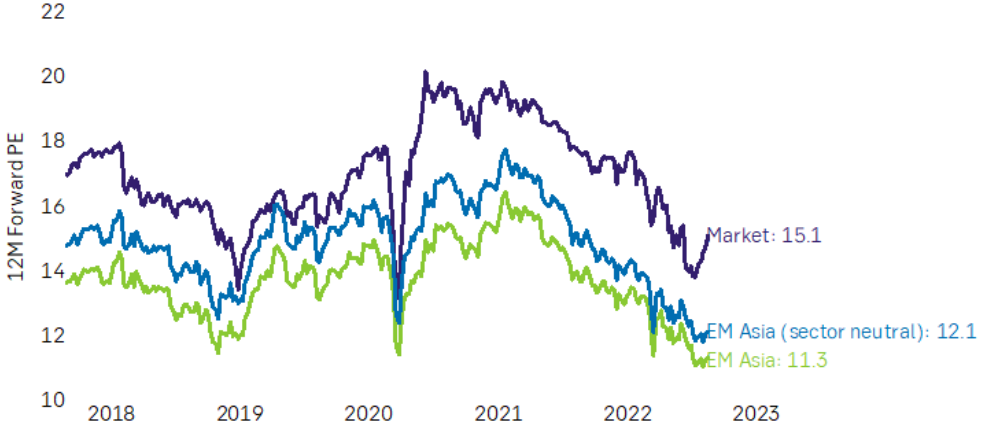
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



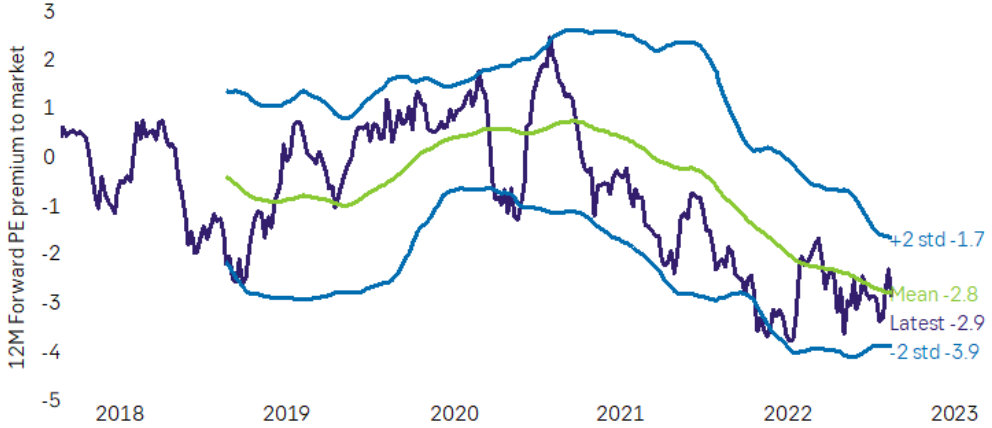
Source: SEB House View

EM Ex Asia – Neutral

Countries in the region face challenges from EM debt crisis and higher costs

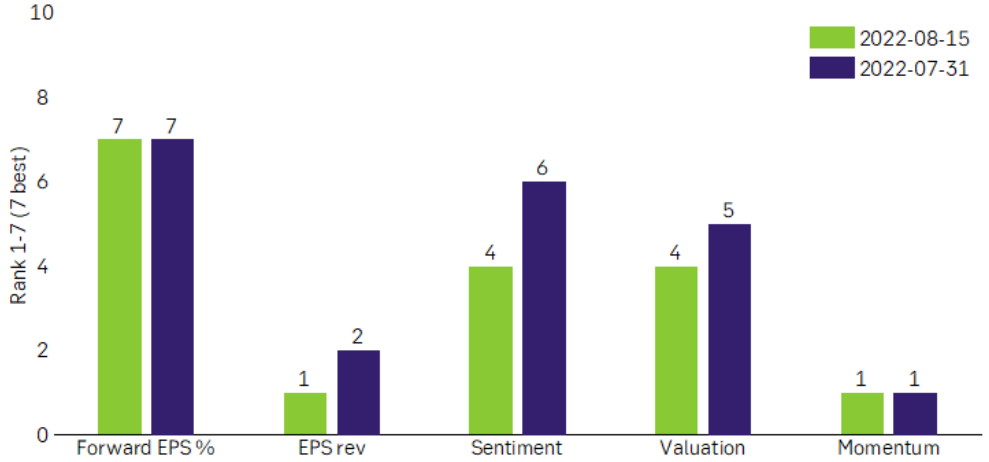
- Default risks in EM have increased due to excessive borrowing over the past decade and higher interest rates amid global central bank tightening
  - Higher bond yields and a stronger USD have made servicing of dollar-denominated debt more expensive for economies and companies in this region
  - Investors also demand higher yields for EM debt after Russia, Belarus and Sri Lanka defaulted this year
    - Many frontier markets, which are at risk, are in Africa and Central America However, Brazil and Mexico, the largest countries in this region, have low default risks due to large reserve holdings and small proportion of USD-denominated debt, which should balance the risk
    - Nevertheless, lower demand for EM debt limits access to capital markets for companies in this region
- In our model, EM Ex Asia ranks at the top on the EPS outlook among all regions

Figure 1: Standardized relative valuation – Current constituents



Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents

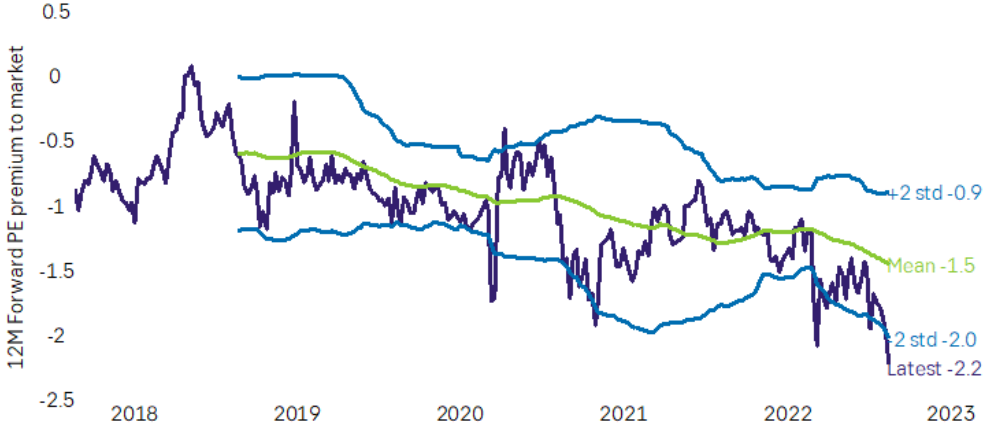
Source: SEB House View

Europe – Underweight

We remain underweight to the region because of the challenging backdrop and risks

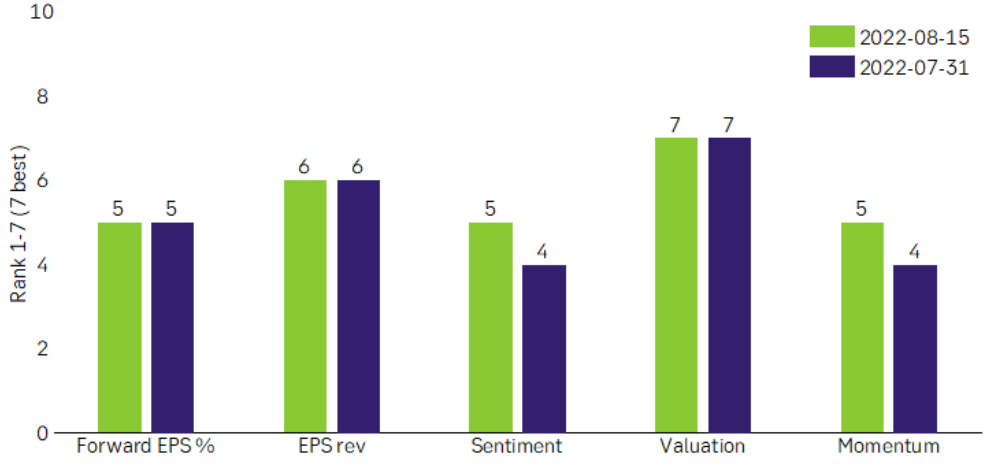
- Equities have de-rated over concerns about a European recession this year, after the Russian energy company reduced its gas exports to the region
  - Confidence in Germany, which is heavily dependent on Russian gas, has fallen to new lows for both consumers and businesses
- The region trades more than two standard deviations below its historical market premium and ranks best in terms of valuation, against other regions
- EPS revisions have been positive, and the region is expected to post double digit earnings growth in the next 12 months
  - Despite strong fundamentals, downside risks are high due to the war in Ukraine and the EU's conflict with Russia following the bloc's sanctions on the country
- Furthermore, the ECB is expected to raise rates by 50 bps next month, despite the difficult economic backdrop
  - Tighter financial conditions will further weaken confidence further and ultimately lead to even lower consumption and growth

Figure 1: Standardized relative valuation – Current constituents



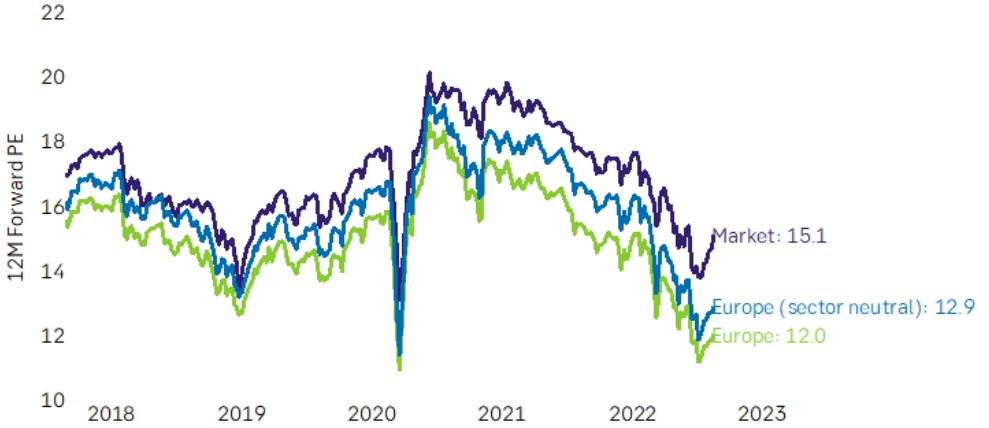
Source: SEB House View

Figure 2: Europe ranks higher than other regions on valuations which has de-rated



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



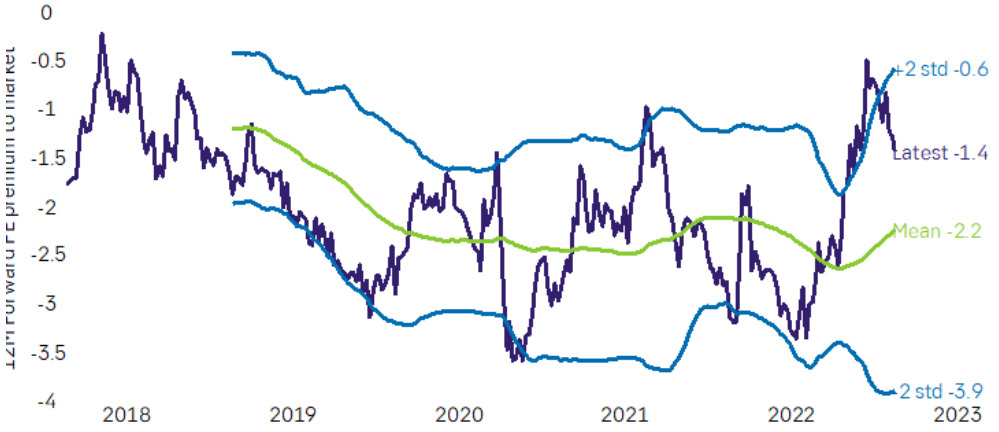
Source: SEB House View

Japan – Underweight

We remain slightly underweight Japanese equities as we believe that the global macroeconomic backdrop will lead to a deterioration in the country's exports

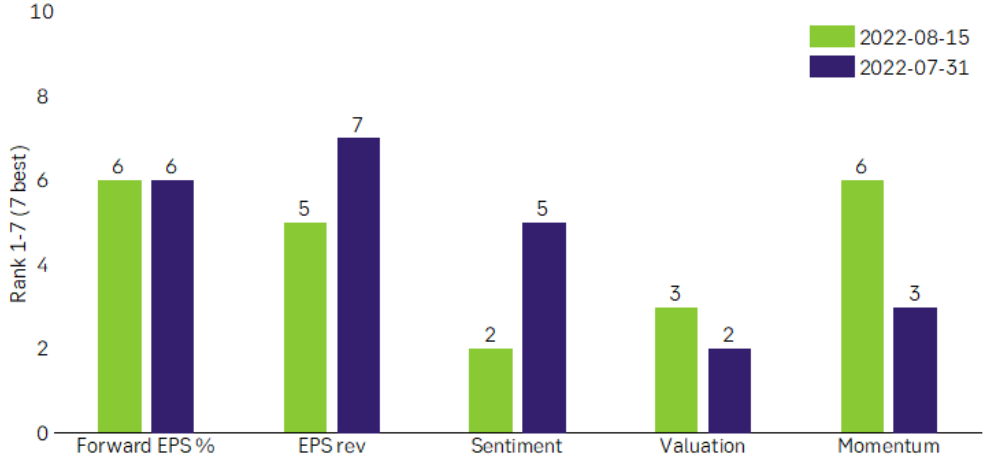
- Japanese production rebounded in June from the lower the levels in May, when lockdowns in China led to a decline in output
  - However, slowing consumption momentum in June-July after an upturn in covid cases and tough weather conditions weigh on the country's outlook
- Japanese companies reported 2Q growth in in operating and net profits, beating expectations that earnings would fall
  - Companies in sectors that continue to benefit from the reopening trade and a depreciation in yen have posted solid earnings
  - However, we believe that the boost from the reopening will eventually fade and that the country's exports will decline as US and Chinese demand for durable goods falls amid a slowing global economy

Figure 1: Standardized relative valuation – Current constituents



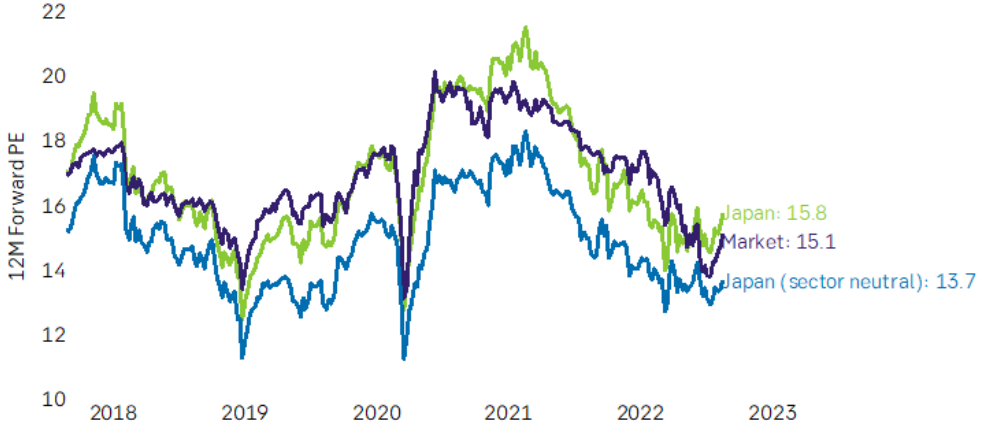
Source: SEB House View

Figure 2: Japan EPS outlook scores remain high, but we see foreign demand falling



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



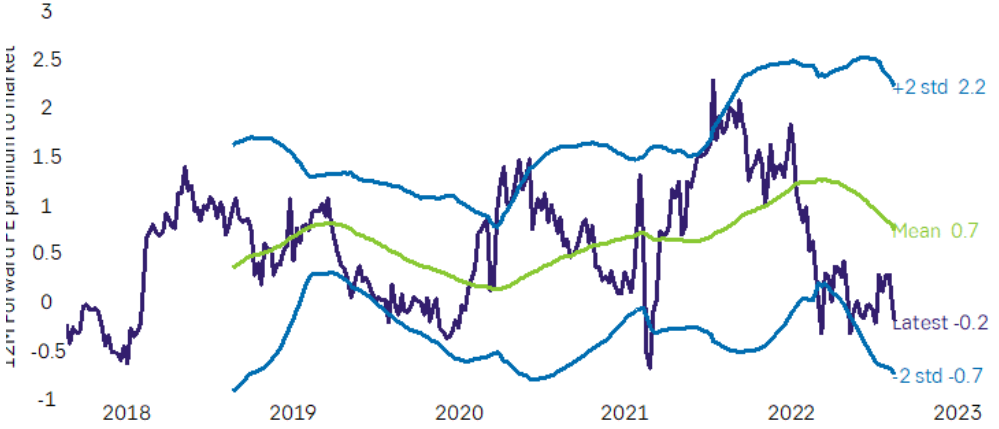
Source: SEB House View

Nordics – Overweight

The region's export sectors will likely benefit from a weaker SEK while subsidies can mitigate the negative impact from higher energy prices in the short-term

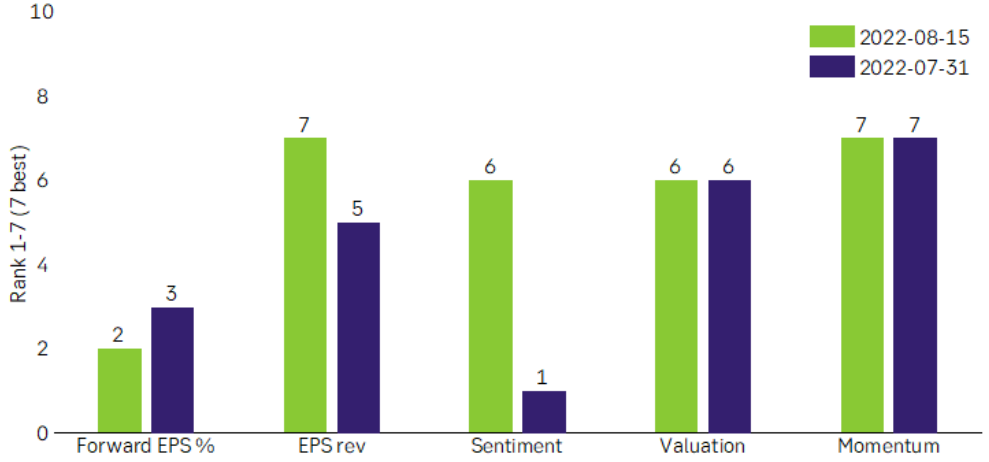
- The SEK has weakened ever since the Russian invasion of Ukraine began, which should benefit the export-oriented region
  - As long as the war and gas situation in Europe persist, the pro-cyclical SEK will come under pressure
- Growth is expected to decline and unemployment to rise as high inflation takes a toll on household consumption
  - Strong public finances allow Nordic countries to provide fiscal stimulus to households affected by rising prices
  - Tight labor markets in the region also provide a better starting position, since it will take longer time before unemployment reached a high level here
- The Nordics achieve the highest ranks on EPS revisions and momentum, in our Region Score

Figure 1: Standardized relative valuation – Current constituents



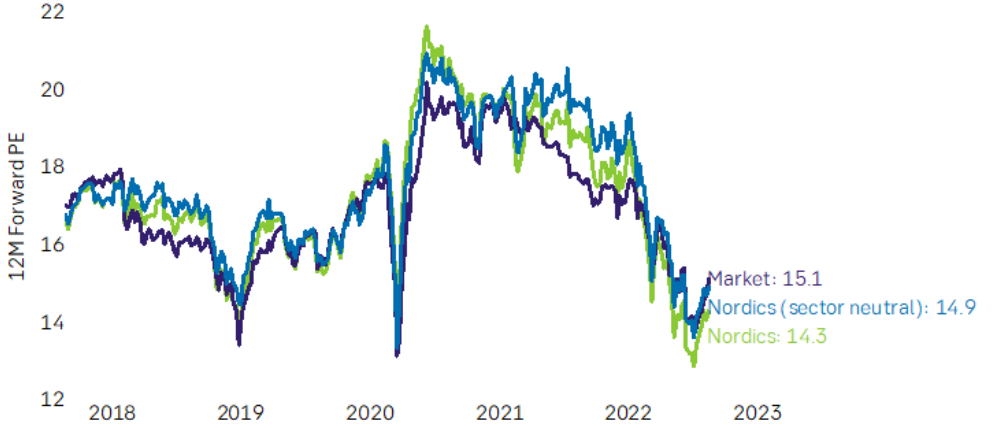
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



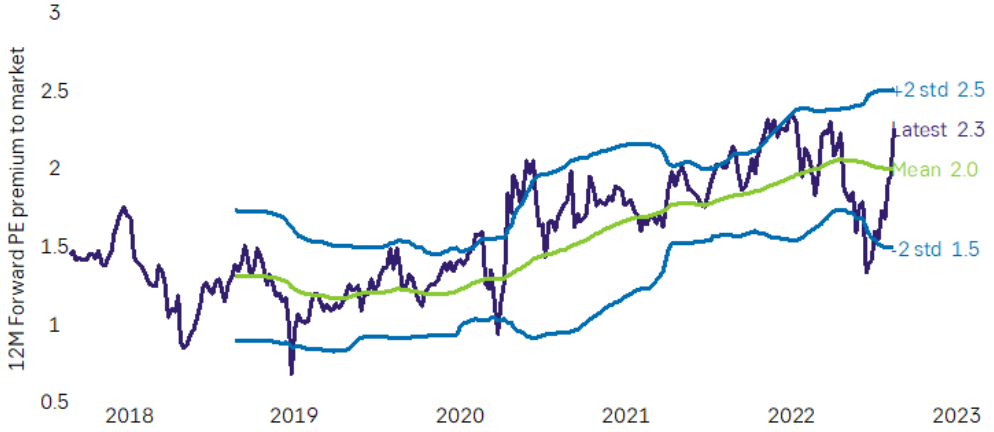
Source: SEB House View

North America – Overweight

Macro in the US outperforms macro in other regions

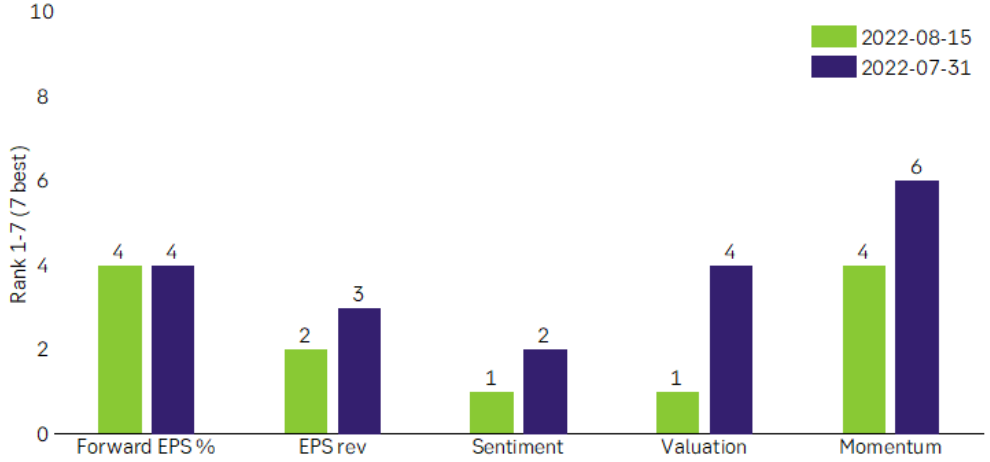
- Macro data in July show signs of a slowdown in the US economy, but PMI:s are above 50, indicating that the economy is still expanding
- The strong US labor market and decent consumption also signals that the economy is not in a recession, despite entering a technical recession in 2H
  - However, rapid wage growth has become a concern for inflation and thus growth
  - Wages have soared as companies face labor shortages and the participation rate remain below pre-pandemic levels , but we believe that wage pressures will ease as the labor market peaks in the coming months
- The region is also affected by higher energy prices like other regions, but to a much less extent than Europe, since it does not have a direct link to Russia
- The region benefits from its safe-heaven status amid the war in Ukraine, as investors rotate into less risky assets
- Downside risks include longer-than-expected time until a Fed pivot or inflation peak

Figure 1: Standardized relative valuation – Current constituents



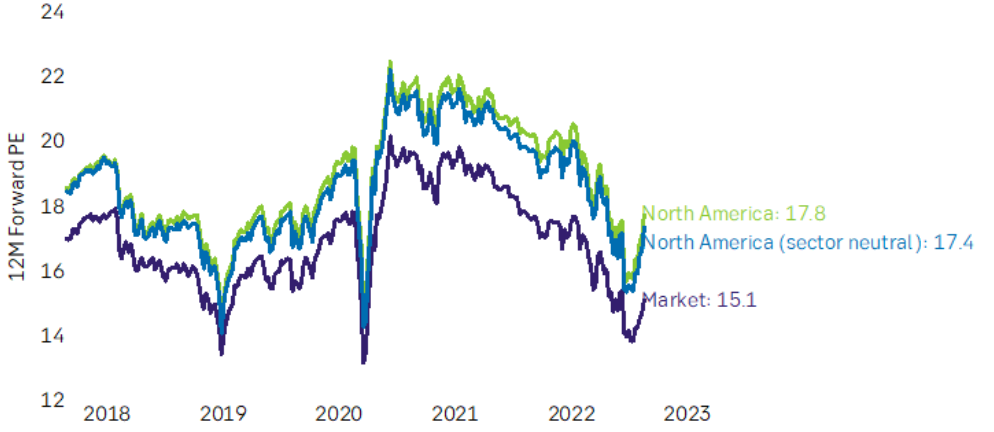
Source: SEB House View

Figure 2: Contribution to House View Region Score



Source: SEB House View

Figure 3: Absolute valuations – Current constituents



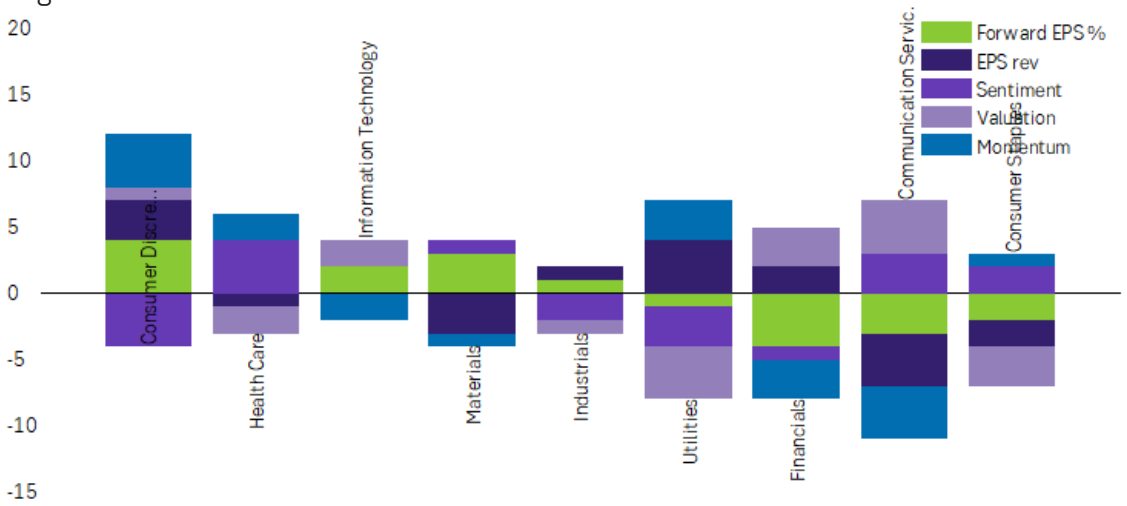
Source: SEB House View

Sector Overview

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

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

Figure 1: SEB House View sector score



Source: SEB House View

Overweight – Materials, Health Care and Industrials

Materials should benefit from more stimulus from China as demand stabilizes

- Commodities have recently fallen due to a weaker outlook and stronger USD
- Stimulus from China is likely after the weaker activity data, which should stabilize demand for commodities, such as metals, and benefit metals & mining in the sector
- The sector ranks second on EPS outlook versus other sectors, according to our model

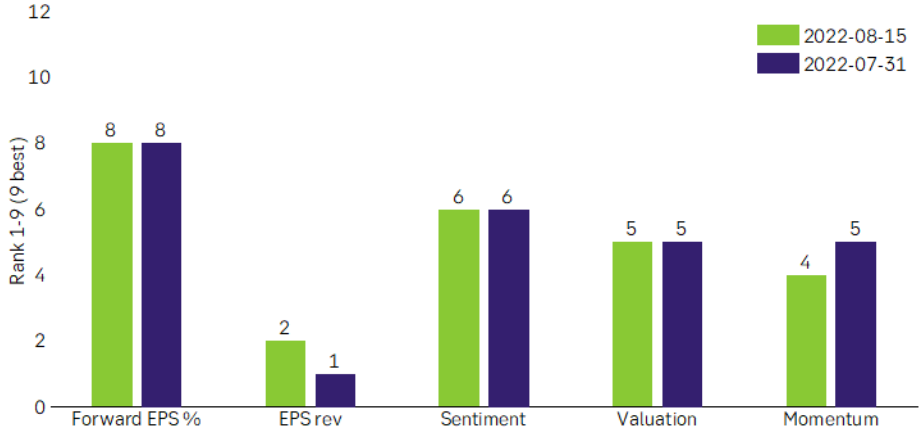
Health Care provides protection against recessionary risks

- The Inflation Reduction Act, which aims at reducing drug costs for Americans, will impact Pharma in the long term, but eventual price reductions will not start until 2026
- In our model, the score on sentiment ranks highest in comparison with other sectors
- We remain overweighted to the healthcare sector due to its defensive characteristics

Biden's $740 bn package should increase US industrial demand

- Declining real estate investments in China will likely weigh on construction demand
- On the other hand, Biden's climate bill, the biggest in climate package in US history, will increase infrastructure spending and demand for machinery, road & rail etc.

Figure 1: EPS outlook for Materials remains attractive

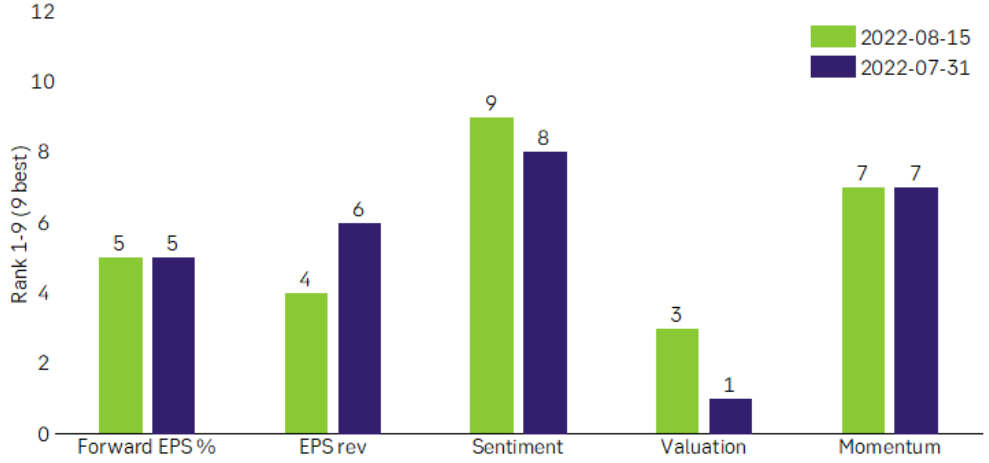


Source: SEB House View

Figure 2: Materials still trade at a discount to the market after the recent rally

Source: SEB House View

Figure 3: Healthcare ranks highest on sentiment (RSI) among all sectors



Source: SEB House View

Underweight – Consumer Staples and Utilities

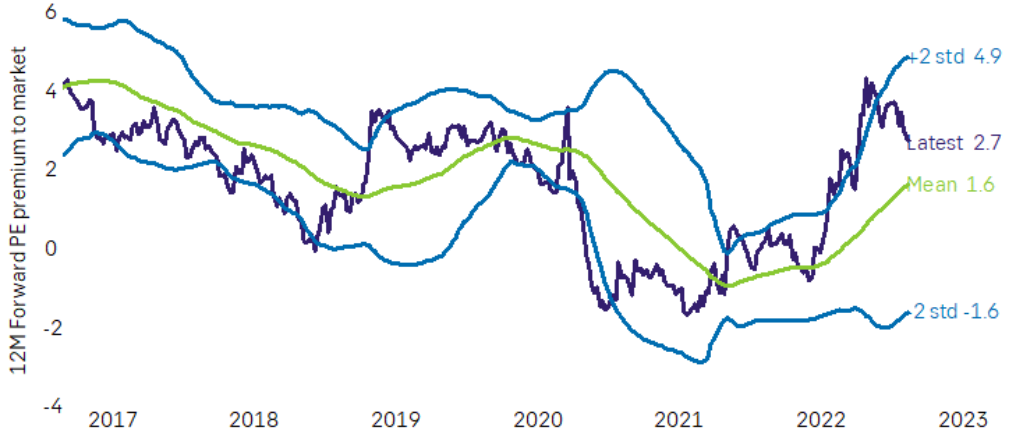
Consumer Staples is assigned the lowest score in our House View Sector model

- We believe that defensive stocks, such as consumer staples, will continue to fall out of favour, as investors rotate back to sectors with a better growth outlook
- Consumer staples also scores the lowest in our model
  - Relative valuations remains unattractive while the EPS outlook looks weak
- Big retailers like Walmart and Target face headwinds from weaker demand in the US
  - Rising prices for food and energy force consumers to spend less on other items, which has made retailers cut prices to reduce excess inventory

We remain underweight in Utilities as rotation out of the sector is likely to persist

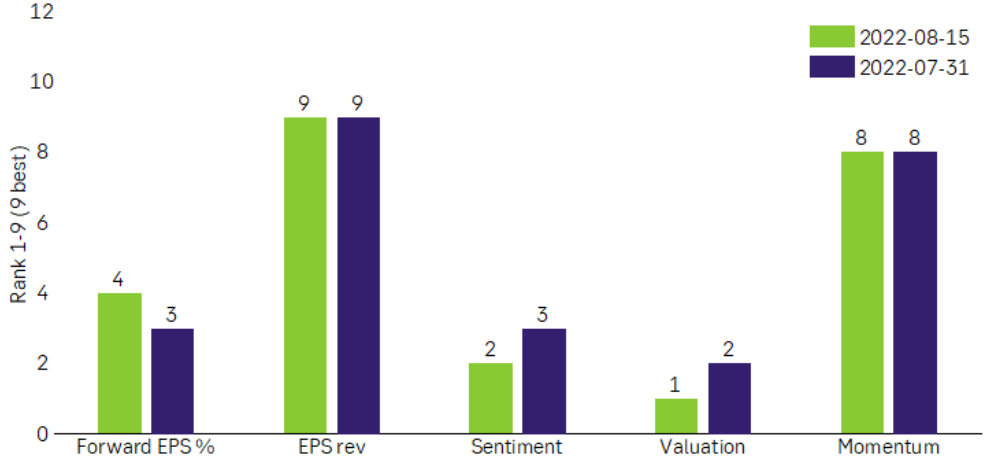
- The Fed and ECB are set to deliver further rate hikes in the next months
  - Sector returns are negatively correlated to bond yields
- We believe that the recent rotation out of the sector will continue as defensive sectors are still expensive and market will search for stocks with strong growth prospects in a slowdown

Figure 1: Consumer Staples has declined amid a fall in bearish sentiment and bull rally



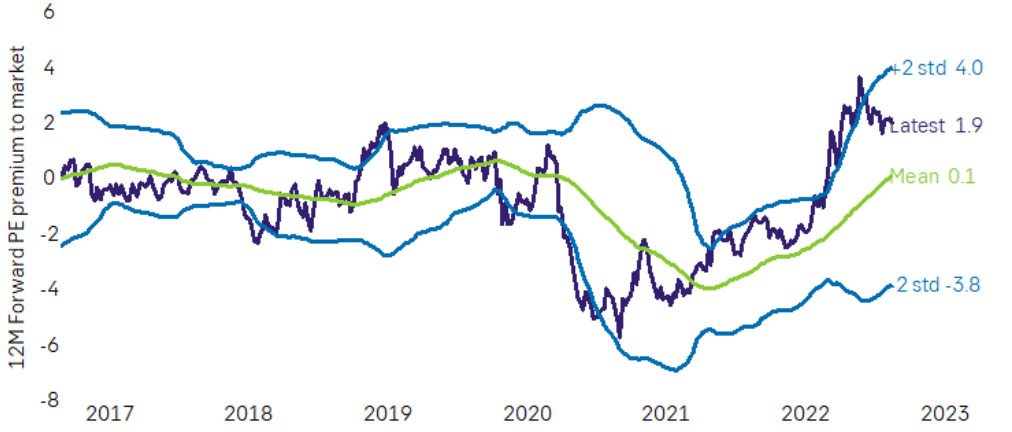
Source: SEB House View

Figure 2: Utilities is now trading at high relative valuations levels compared to history



Source: SEB House View

Figure 3: Utilities have de-rated as investors start to rotate back to riskier stocks



Source: SEB House View

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