Nordea Boutiques
Economic Outlook 2018

*investing for their own account - according to MiFID definition*
Introduction

Economic Outlook 2018

Each year, we compile the investment outlooks for the coming year from our various internal and external boutiques. We are pleased to share this 2018 collection of outlooks on each boutique’s respective asset class with you. We thank you, valued client, for investing with Nordea and wish you a successful 2018.

Asset Management at Nordea

As an active investment manager, Nordea Asset Management manages asset classes across the full investment spectrum and aims to serve its clients in every market condition. Nordea’s success is based on a sustainable and unique multi-boutique approach that combines the expertise of specialized internal boutiques with exclusive external competences allowing us to deliver alpha in a stable way for the benefit of our clients.

Internal boutiques

We have established segregated teams for key asset classes, allowing each team to focus on their primary activity: managing money. This means retaining competence centres that leave freedom to the investment managers. In addition to our Nordic expertise, we have built well-established track records over the years in both equity and fixed income strategies ranging from Credit and Covered bonds to Global, European and Emerging Markets equities as well as Multi-Assets Solutions.

External boutiques

Nordea External Partners team aims to meet investor needs by selecting best-of-breed asset managers who can generate alpha in specific regions or asset classes. The rationale is to concentrate on boutiques focused purely on money management in the belief that fund distribution distracts investment managers from their primary objective: generating exceptional investment performance.
The cyclical recovery has run full steam ahead in 2017, resulting in extremely high readings of economic confidence across the globe. While elevated confidence confirms the cyclical strength, it also is a typical late-cycle phenomenon, as levels like this normally occur a few quarters before the business cycle rolls over. This is because the strong recovery forces central banks to scale back stimulus and eventually tighten. The US Fed is clearly ahead of the curve in this process.

Monetary stimulus has arguably been the most important driver for both markets and the economy since the financial crisis. A removal or even reversal of this driving force is decisive, to say the least. While the very elevated confidence levels do not contradict further upside in risk assets in the coming quarters, it does mean that downside risks are rising in the medium term. Hence, it might be a good time to book profits in areas of the market that have run hot in 2017 and bring down return expectations across main asset classes. As long as confidence continues to be elevated investors are home free. We expect this to be the case in the first half of 2018. But as soon as a downward trend crystallizes, caution is warranted. The asset return cycle, measuring risk asset performance against safer assets, is typically peaking when the broad thinking is that nothing can go wrong.

A cyclical signpost currently flashing amber is the flattening US yield curve. An inversion normally signals a US recession ahead. And as we know, equity bull markets do not die of old age but rather because the US enters a recession. We are not there yet (see graph), so why worry? The yield curve flattening mirrors rising short-term rates (proxy for financing costs) and range-bound long-term rates (proxy for potential returns). The resulting monetary tightening normally makes the credit cycle turn. This should lead cross-asset volatility higher (graph). Unless US tax cuts reverse this trend, the credit cycle also points towards lower growth in 2018 and 2019.

The time is ripe to scale down exposure in markets that are most exposed to tighter monetary conditions, a turning credit cycle and more volatility. High yield credit might be the first to come under pressure. Equities should show decent returns until monetary tightening begins to bite the real economy, which might be a second half story. Consequently, we currently prefer investment grade corporate bonds over lower rated segments.

A final word on recession risks and therefore risk of a peak in equities: the recession signal from an inverted yield curve becomes even stronger if credit spreads also reach a cyclical trough. While there are signs that high yield spreads might have reached their nadir, the question is when the yield curve could invert. We think there is very limited room for long-term rates to move up in the US due to low potential growth and low inflation pressure. If the Fed continues with the current pace of rate hikes, the curve could invert once we move into the second half of 2018. If history is any guide, this would point towards a recession early 2019 and a peak in equities in Q3 or Q4 2018. The bull market could get another boost if an inversion were to be met by renewed Fed easing, re-steepening the curve and fending off recession risks.
Going into 2018, we expect economic growth and earnings momentum to remain strong. Earnings revisions for 2018 have been – if anything – positive, pointing to yet another strong year for earnings growth. Amongst regions, Emerging Markets (EM) still offer a lot of potential as the relative valuation vis-a-vis developed markets (DM) is attractive and the earnings growth differential is also in favour of EM. However, one thing to look at within EM is the concentration of earnings growth, which is currently largely coming from expensive IT stocks, while it is more balanced in the US and DM in general. Even if overall catalysts for equities are positive, a lot seems to be priced into the current demanding valuation levels, which makes equities more vulnerable to downside risks.

We still have a high conviction in our Stable/Low Risk Equities despite the recent underperformance, as market sentiment is more reasonable here and these stocks are, in our view, valued more fairly. All in all, as an asset class it’s unlikely that equities will repeat their performance of 2017 but we still expect that the current earnings tailwind will persist in 2018.

Regarding fixed income, the US curve has flattened, making duration risk premia less attractive. The short end of the curve has moved up following the three rate hikes we had in 2017, while the long end remained anchored around 2.5% (10Y) due to subdued inflation (PCE and wages) and productivity. A move up in any of these variables could be detrimental to valuation as duration will become less attractive.

As for credit, strong risk appetite, supportive macro momentum and subdued default rates have pushed valuations to more stretched levels, pushing high yield (HY) credit spreads close to their 2007 lows. Given this, it’s not so clear how likely is that the asset class can benefit from further spread compression as we have seen in previous years. Furthermore, lower coupons (carry) imply that even a small spread widening can hurt performance dramatically. This is why, with rising financing costs coupled with historically low default rates in DM, we are relatively more optimistic about EM bonds where spreads are higher, overall credit quality is stronger and fundamentals are somewhat more robust.

From a long term perspective, it is important to highlight that expected returns for the next decade will be very different from the returns we have seen over the last 10 years. This is especially true for fixed income, where expected returns are meagre across the asset class. As such, equities have been very much in the spotlight as the main source of returns for the coming years; here the question is whether they will be able to deliver those expected returns without any significant increase in volatility or any sizeable correction given the currently high valuation levels.

Now, more than ever, investors will need to keep an eye on diversification and this is where our risk balanced approach can come in handy. We are confident on the capability of our portfolio to continue delivering capital preservation and stable returns over its 3 year investment horizon in the same manner that we have consistently done over more than a decade.
2017 was a year of a synchronised recovery globally as a combination of loose monetary policies, an accelerating inventory cycle and increased employment supported many parts of the economy. Although the Federal Reserve is increasing interest rates in the US, we expect loose monetary policy to remain in place globally. We are cautiously optimistic regarding the duration of the current economic cycle. However, throughout 2018 we expect increased attention towards the potential of a weaker 2019 as the inventory cycle fades.

The Nordic equity market had an above-average year but with large deviation between sectors. The Materials and Health Care sectors had double-digit gains while the IT and Consumer Discretionary sectors experienced declines. Throughout the year there has been an ongoing tension between shifting consumer trends and the consequences of tax changes in the US, among other things. At an aggregate level, the Nordic market is priced at 16x 12 months forward earnings. This is a level that is high in a historic context, the 10 year average being 14x. However, bearing low interest rates in mind, the level is not considered excessive.

A large part of the Nordic universe is exposed to the global economy given the companies’ history of expanding internationally. This, combined with quality business models and strong corporate governance, is a key attraction of the Nordic market. However the Financials and Telecom sectors, as well as smaller companies, are more dependent on the macro development in the Nordics where we are seeing a broad-based above-trend development.

In Sweden, the combination of urbanisation, strong export markets and a very accommodative Riksbank policy has positively influenced Swedish GDP development in recent years. Going forward a weakening housing market may curb domestic demand, especially consumer-facing companies.

In Denmark, consumer spending continues to be supported by rising house prices and stable-to-declining interest expenses. European export growth is a positive factor impacting employment in a supportive way albeit financial companies’ earnings continue to be held back by negative interest rates related to the country’s currency peg to the Euro.

Finland is clearly starting to benefit from an export-driven rebound. Despite underlying structural issues, domestic demand is likely to remain positive with support from the construction sector and consumer sector in particular.

In Norway, oil and oil-related companies have continued to scale back investments. However oil companies’ investment plans look to bottom out in 2018. The domestic economy has held up surprisingly well and with an improving labour market, job-creation is supporting domestic demand.

In general, we are cautiously optimistic regarding the duration of the current economic cycle. With this framework in mind, well-run companies with solid balance sheets and a discretionary opportunity to allocate capital in an accretive way should remain a fertile ground for stock ideas.
European Equities

Nordea European Equities / Fundamental Equities Team
Nordea 1 – European Focus Equities Fund

• Synchronised global growth stimulated the European economy during 2017
• Good corporate earnings underpin equity valuations
• Improving labour markets are supportive for increased consumer confidence
• Global macro and European political risks remain on the horizon

European equities delivered healthy double-digit returns during 2017, outperforming both US and global equities, but lagging the very strong performance of emerging markets. Fundamentally, this development was driven by GDP growth which accelerated to above 2% during 2017, as well as by corporate earnings growth moving into double-digit territory. Valuation multiples remain relatively attractive in a global context and imply that Europe is still trading at a discount. The European economy has benefited from stronger global growth and continued monetary stimulus that have led to rising corporate earnings. The Eurozone unemployment rate has dropped from 12% in 2013 to below 9% during 2017, clearly indicating a firming up of the economy and resulting in improved consumer confidence.

Looking into 2018 there are opportunities and threats on the horizon. The opportunities relate to: continued economic recovery in Europe, spillover from healthy global growth, stimulative monetary conditions, a stabilised financial sector with increased regulatory clarity and European companies narrowing the profit margin gap relative to US peers. The threats on the horizon relate to: European politics (Brexit, Italian election), global growth potentially negatively affected by changing US trade policy, US economy overheating, China and Emerging Markets slowdown, Fed rate rises and inflation overshoots and higher commodity prices.

Bearing all this in mind, the European recovery could have further potential. Exporters are benefitting from accelerating global demand. A healthier financial sector points to sustainable domestic credit growth. Capital investment has stabilised and could further improve with rising corporate profitability. Inflation seems to be under control and the ECB remains supportive, despite intentions to slow the monetary stimulus. All in all, an improved European economy bodes well for a narrowing of the underperformance of European equities when compared to the European/US growth differential.

The US is in an extended stage of its business cycle and faces slowdown risks, but at the same time hopes for infrastructure and tax incentives are benefitting the economy. Rising rates in the US have become a reality, but inflation expectations remain surprisingly contained. A change to this dynamic could pose clear risks of negative spillovers to European equities.

China and Emerging markets have been key drivers of global growth during 2017. Demographics and structural demand drivers for infrastructure and technology and rising living standards continue to benefit many European companies. However, slowing Chinese stimulus combined with a stronger USD could lead to tensions in the region and a weaker backdrop for European equities as a consequence.

We remain constructive on European equities while we emphasise caution as valuation is no longer as supportive as it has been in previous years on an absolute basis. On a relative basis European equities are still very attractive compared to global — and especially US — equities.
North American Equities

Eagle Asset Management, Inc.

Nordea 1 – North American All Cap Fund

- US policy supportive of continuing growth with tax and regulatory reforms still on the agenda
- Strong economy can tolerate expected modest increases to interest rates
- Equity markets remain supported by still-low rates, but expect a normalisation back to fundamental investing which supports more value-oriented strategies

Looking forward to 2018, we believe the outlook for the US economy is similar to the view we had a year ago. We expect continued moderate economic growth, growing corporate profits and further normalisation of monetary policy. As the current economic expansion approaches its ninth anniversary, some investors have expressed concern that a recession is coming since the current expansion already has lasted more than twice as long as historical averages. We do not share this concern. Expansions do not die of old age but, rather, because of policy actions or major exogenous events. We believe that current policies are supportive of continued growth. In particular, on the fiscal and regulatory fronts, policies are becoming even more conducive to growth. A major tax-reform bill has recently been passed by Congress with a key feature being a major reduction in the corporate tax rate. By some estimates, that could add about 10% to S&P 500 earnings in 2018. In addition, favourable terms for repatriation of the USD 2-3 trillion in US companies’ cash stranded overseas is likely. That, in turn, could unleash a number of favorable actions for the US economy and for shareholders. On the regulatory front, great progress in rolling back many growth-inhibiting policies of the previous administration already has been made. But further regulatory relief, particularly in the area of financial institutions, is in prospect.

Another way to think about the current situation is that we are just a couple of years into a “normal” economic environment. By this, we mean that the once-in-a-generation financial crisis that occurred nearly a decade ago left consumers and businesses in an extended period of fear and caution that only time could heal. The period from 2008 until just recently was depression-like in many ways: very slow growth, stagnant incomes, deflationary tendencies and a reluctance of businesses and consumers to spend and invest. Monetary policy came to the rescue with the most aggressive interest-rate and quantitative-easing programs ever seen. Monetary policy kept the real economy growing, if only slowly, but the major impact of monetary policy was on financial markets where a global bull market in equities and bonds ensued.

Time has passed. Balance sheets have improved. Consumer incomes are growing again. Business and consumer confidence are near record highs. And the United States is fortunate to have a business-friendly government eager to promote economic growth. The next recession and bear market are well over the investment horizon, in our view.

The recent appointment of Federal Reserve Governor Jerome Powell as chair indicates to us that President Donald Trump wants a continuation of the gradual normalisation of policy rather than radical change. As with this year, we believe three Fed interest-rate increases are likely in 2018. As equity investors, we do not fear modest increases in interest rates. Historically, rising rates from a low level – in a low-inflation environment – have not been negative for stocks. Price-to-earnings ratios are a bit above average but, compared to current interest and inflation rates, they are well within historical norms.

Just as in 2017, we believe the broad stock market averages can rise in line with earnings in 2018. However, we believe that a change in the nature of the market is likely. During a period of economic uncertainty, investors tend to flock to a relatively small number of companies with strong revenue growth and good earnings visibility. Valuation takes on a secondary role if it is even considered at all. That is the milieu of growth and momentum investing which has been dominant recently and especially in 2017. Looking forward, we believe — for a number of reasons — there will be a revival of value investing and that our strategy and portfolio are well-positioned to participate.

Source: Eagle Asset Management, Inc. Date: December 2017. Unless otherwise stated all views expressed are proprietary to Eagle Asset Management, Inc.
Latin America has gone through a consolidation period of more orthodox macroeconomic policies in 2017, following 2016’s year of changes of political regime in countries like Argentina, Brazil and Peru. As a result, GDP growth for the region improved in 2017 and is expected to accelerate in 2018 with obvious positive impact on the equity markets in the region. The earnings recession in the region is over and recovery mode is in place, as the graph below shows. Therefore we believe earnings growth will drive Latin American equity markets in 2018.

We see Brazil as the main source of upside for the Latin American market in 2018. The country is responsible for almost 60% of the MSCI Latin American Equity Index. Its economy is coming out of the strongest recession ever recorded, and it is already in a recovery mode: we expect the Brazilian economy to grow 3% in 2018. The Brazilian Central Bank (BCB) has successfully controlled inflation, allowing it to implement an aggressive expansionary monetary policy - the overnight rate fell from 14.25% p.a. at the end of 2016 to 7.00% p.a. at the end of 2017, bringing down the whole yield curve. Inflation is now expected to end 2017 and 2018 below the BCB’s target. The history of high interest rates in Brazil has made the country’s equity market one of the most interest-rate sensitive in the world, and we believe that most of the positive effects of lower rates are still to come to the equity market, as corporates’ financial expenses will fall substantially in 2018. This alone would drive earnings growth for 2017 and 2018, but we have also seen revenue growth in corporates’ earning releases, which will feed through to earnings, compounded by operational leverage, where the change in earnings growth is larger than the change in revenue growth.

We also see opportunities elsewhere in the region. Argentina is making structural reforms and entering a benign period of the economic cycle. The macroeconomic outlook for Peru is also for improving economic activity throughout 2018, provided by the mining and the infrastructure sectors. From a fundamental standpoint, Latin America should be in a sweet spot in 2018, but politics may impose binary situations for the most relevant countries in the region and asset managers will have to act accordingly. As we write this article, we are close to the second round of presidential election in Chile. There will also be presidential elections in Brazil, Mexico and Colombia in 2018 and we see binary possible outcomes in Chile, Brazil and Mexico. By binary we mean voters will have to choose between an orthodox and a populist government, and this will determine market behaviour, in our opinion.
2017 turned out to be a very strong year for Asia and Emerging Markets (EM) in general. EM was one of the best performing asset classes, with Asian equities (particularly technology stocks) being the main driver of this strong performance.

Regarding the upcoming year, we remain positive on Asia and on EM. Most EM economies have significantly improved the current account situation, fiscal situation, and their USD funding situation since 2013. This has taken quite some time but has resulted in significant improvements on many of these economies. For that reason, we believe that a USD rise and/or Fed rate hike cycle (if it comes on the back of good global growth) will not be significant issues for EM from a structural perspective. However, short term volatility cannot be ruled out: this would represent a buying opportunity. Additionally, we are finally seeing some real reforms which will be positive from a longer term perspective. India and China are leading here. Furthermore, we are starting to see “supply-side” management in a number of sectors, which should get pricing power and margins back to the companies and support the case for a longer term earnings up-cycle. The potential risks that we can see may arise from changes in the global economic landscape, from unexpected political changes in countries like India or China or from a “black swan event”, such as North Korea triggering a geo-political crisis.

EM still remain relatively cheap and since they also offer a good economic growth outlook with many sectors showing favourable dynamics, we see potential for a favourable earnings environment and even for some rerating, which brings a very positive risk/reward situation and could produce a good return in 2018. We continue to favour Asia, and within Asia we also continue to be weighted towards India (mostly Financials, Real Estate and Consumer) and northern Asia, where China (Information Technology Healthcare, and Consumer), South Korea and Taiwan (Information Technology) continue to offer very attractive stock picking opportunities. It is, of course, very important to be more cautious and selective now given the strong returns in 2017, but we feel confident about the stock picking opportunities we continue to identify.

Given favourable growth dynamics and limited risk over the near term, very attractive long term fundamentals (demographics, growth, reforms, productivity gains, adoption of technology, etc.), and still low valuations with limited return expectations, we see an attractive risk/reward for investors in EM and Asia in 2018.

Source: Nordea Investment Management AB. Date: December 2017. Unless otherwise stated all views expressed are proprietary to Nordea Investment Management AB.
2017 turned out to be an exceptionally strong year for Chinese Equities, driven by easing concern on RMB, strong earnings growth with positive revisions, and moderate multiple expansion. Looking forward, we remain positive and think China holds some of the very best investment opportunities in the world today. We continue to favour opportunities in technology, healthcare and the consumer markets as China successfully transforms into a consumption-led economy in the coming years.

We have long been believers of China’s historic transition from an investment-led growth story to a consumption-led and services-led one. Service sectors already account for more than 50% of China’s GDP and most of the growth. From a bottom-up perspective, we see the best opportunities in 1) sectors that are well positioned to benefit from the gradual yet enormous transformation, 2) industries in which Chinese businesses have strong and sustainable competitive advantages, and 3) companies with dominant market positions protected by a wide moat.

In our opinion, internet, e-commerce, online games, electric vehicles, artificial intelligence, healthcare services, and consumer goods and services are industries that hold the most potential. The structural winners in these markets delivered between 15% and 60% revenue growth in 2016, and we expect growth to have stayed at a similar level in aggregate in 2017. As they are still trading on very reasonable multiples given their high return profile and long runway for growth, we expect them to continue to deliver superior compound returns in the long run.

The macroeconomic backdrop is also favourable to equity owners. Following the Communist Party Congress in October, the policy framework for China is very stable for next 5 to 10 years, which stands out even more in the global context. Material progress has been made on supply-side reform; industries burdened with massive excess capacity are finally able to enjoy rising utilisation, strong earnings growth and cash flow. These strong cash flows from operations are helping highly-leveraged SOEs to repair their stretched balance sheets. As a result, in 2017, for the first time in decades, we are seeing China’s debt to GDP declining on a sequential basis.

Against a stable policy and macro environment, a selective investor should be able to find strong earnings growth of more than 15% in 2018. Starting with a reasonable level valuation, this market is well positioned to deliver superior long term return to investors.
2017 has been a rewarding year for Indian equities with MSCI India delivering 38.8%, outperforming MSCI EM by 1.4%. The implementation of the Goods & Services Tax (GST), Bank Recapitalization Plan and strengthening domestic flows into equity markets were key contributing factors to the bull run we have seen in 2017. The Government’s continued efforts to implement bold and ambitious reforms are expected to bring long term benefits to the economy. India’s GDP growth recovered in Q2FY18 (July - September 2017) to 6.3% year-on-year after slowing to a three-year low of 5.7% in the last quarter. International credit rating agency Moody’s sovereign rating upgraded to Baa2 from Baa3 after 14 years and a jump of 30 notches to rank 100 in the World Bank’s ease of business survey, reflecting the structural improvements in the economy.

To stimulate investment demand in the economy, the Government launched two major reforms.

1. The Bank Recapitalization plan worth USD 32.7 billion and targeted infrastructure spending, e.g. the Bharatmala highway construction scheme, worth USD 108.5 billion (INR 7 trillion). The move to recapitalize public sector banks is expected to help resolve the non-performing loans (NPL) problem, which in turn, could aid the recovery of private capital expenditure. Public sector banks could also benefit due to credit expansion after a prolonged period of single-digit loan growth.

2. The Government’s focus to curb black money, check for tax evasion through unaccounted income and promote digital payments provided visible effects. Demonetisation and stringent policies for real estate and gold consumption have helped to drive India’s savings into financial assets, including mutual funds. Real interest rates, which turned positive in FY15 after almost six years, coupled with significant Government schemes and focus on financial awareness programmes is leading to higher participation in capital markets by domestic investors.

Domestic mutual funds continued to be major participants in the Indian equity markets by investing ~ USD 18 billion versus foreign portfolio flows (FPI) of USD 8 billion during 2017 (January 2017 to 22 December 2017). Much of the domestic flows came in the form of Systematic Investment Plans (SIPs) in mutual funds, with monthly flows growing from USD 635 million (January 2017) to USD 914 million (November 2017). SIP flows have reached USD 8.2 billion in 2017 (January to 30 November 2017) and this is expected to be a major investor category going forward, along with domestic pension funds which have started allocating to Indian equities through ETF’s in recent years.

In 2018, we expect the Government to focus more on fine-tuning and completing the reforms undertaken up until now rather than embarking on more ambitious ones. It will continue to prioritise spending on infrastructure, particularly roads and railways, and boost its allocation to affordable housing and rural development, while still aiming for its fiscal deficit target of 3% of GDP in Fiscal Year 2019 (April 2018 - March 2019).

Corporate earnings are likely to grow in the medium-to-long term due to increased formalisation of the economy, which in turn can improve the market share for organised players. Increased formalisation of the economy, pick-up in credit growth, increased capacity utilisation over the next two years and the low base effect will be the key drivers for pick up in earnings. On the valuation front, while Indian markets are not cheap, we believe they are not yet in “bubble” territory.

We remain bullish on India over the long term, given its favourable demographics, democracy, high savings rate and good long term growth potential. However, in the near term, markets could see a phase of consolidation and volatility on the back of rising oil prices, budgetary announcements in early February 2018 and surprises in state elections.

Source: ICICI Prudential Asset Management Company Ltd. Date: December 2017. Unless otherwise stated all views expressed are proprietary to ICICI Prudential Asset Management Company Ltd.
At the end of 2016, covered bond spreads were wide, and therefore spreads looked attractive going into 2017. ECB buying, lower funding need (due to Targeted Longer-Term Refinancing Operations, TLTROs), and a positive risk sentiment are the main factors that have driven covered bond spreads tighter during 2017. The supportive market environment has allowed Portuguese and Greek covered bond issuers to regain market access. It has been a good year for covered bond investors, as the asset class has continued its stable performance throughout the year. In addition, the yield level is only moderately higher than at the beginning of the year.

Going into 2018, the current level of covered bond spreads does not look that impressive in a historical context. Therefore some investors question whether they should be invested in covered bonds or instead look for other, possibly higher yielding, asset classes. But if we look at the relative pricing of covered bonds against other asset classes, covered bonds actually look cheap. If we compare covered bonds with senior bonds, this spread has compressed massively during 2017. In some jurisdictions, such as Australia, we have been able to buy covered bonds at the same spread as senior bonds. From a fundamental perspective this pricing does not make sense, as you get the cover pool for ‘free’. Therefore we advise clients not to chase risk premia as investors are currently not compensated for the additional risk. Instead we suggest investing in safe asset classes such as covered bonds as you don’t sacrifice much yield. By reducing risk, a portfolio is much better positioned for the possibility of a period where spreads widen generally.

The tight level of senior spreads will also incentivise banks to do more of their funding in senior bonds. In order to comply with regulation such as TLAC (Total Loss Absorbing Capacity) or MREL (Minimum Requirement for own funds and Eligible Liabilities), banks will need to issue more senior bonds or other bail-in eligible debt. This will reduce the banks’ funding need in covered bonds. This reduced supply of covered bonds will be supportive for spreads in 2018. From an overall level, we expect new issuance of covered bonds to be close to the EUR 115bn that will be redeemed in 2018. From a demand perspective, the ECB will continue to support the asset class well into 2018. It has announced that from January 2018 it will reduce its Asset Purchase Programme from EUR 60bn to EUR 30bn per month. Many investors have feared this tapering of the programme, but we don’t believe it will have any major impact. We also think the bulk of this reduction will hit the ECB’s government bond purchases rather than the covered bond purchases. Many people are not aware that the ECB has already tapered its purchase programme within covered bonds — just without announcing this. Looking at the chart below, we see that the ECB initially bought around EUR 12bn of covered bonds per month, an amount it has gradually reduced to the current net purchases of EUR 3-4bn a month. Even if the ECB were to reduce this number further it would have a small impact on the market. It is also worth noting that these numbers are net purchases. Many bonds in the ECB portfolio are now maturing and the ECB has committed to reinvest the proceeds of the maturing covered bonds. This means its monthly gross purchases will be much higher. Again, the strong demand from the ECB will continue to be a supportive factor for the asset class going forward.

Nordea Danish Fixed Income & Euro Covered Bond Team
Nordea 1 – European Covered Bond Fund, Nordea 1 – Low Duration Covered Bond Fund
• Covered bonds offer good risk-return for 2018
• Technical factors remain supportive for covered bonds
• New product offering: Nordea 1 – Low Duration Covered Bond Fund

Source: Nordea Investment Management AB. Date: December 2017. Unless otherwise stated all views expressed are proprietary to Nordea Investment Management AB.
In 2017, the European High Yield (EHY) market returned 6.77%, as per the Merrill Lynch European Currency High Yield Constrained – Total Return Index EUR Hedged (“the EHY market”). Unlike 2016, 2017 started the year on a strong note, with solid returns extending until October, after which November and December printed more subdued returns. During the year, we saw very strong activity in the primary market with record gross issuance. Looking at the quality of the deals coming to the market we continue to see relatively modest levels of leverage, a high level of senior secured deals and a very limited number of aggressive CCC-deals. Uncertainty about future interest rate levels continued to be a source of volatility throughout the year, while the focus on political risk faded somewhat during the course of the year. The developments were supported by the win of the French elections by Emmanuel Macron, which damped the right-wing movements across Europe. Nevertheless, uncertainty about the outcome of Brexit negotiations continues to weigh on financial markets and will likely remain a risk factor until we have more clarity on the outcome.

Towards the second half of the year we saw intensifying geopolitical tensions on the Korean Peninsula due to the war of words between North Korea and US but with modest impact on markets. During the last two months of the year we started to see some more volatility and weakness in credit markets with High Yield markets giving back some of their year-to-date performance – mostly driven by mutual fund outflows and a heavy primary market calendar. Although the selloff was broadly based there were a handful of idiosyncratic names (such as Altice, Astaldi and New Look) leading the decline.

As we look into 2018 we continue to favour the senior secured part of the high yield market, which offers attractive carry combined with downside protection. We expect low default rates for 2018 (1% to 2%) as fundamentals within European high yield continue to look healthy with high interest rate cover ratios and leverage remaining at overall healthy levels. We also expect a continued high level of capital market activities (new issue volumes) combined with upside return potential from rating upgrades (late cycle dynamics in credit markets).

The table above illustrates that current break-even spreads are significantly higher than long-term average default losses. It also shows the relative attractiveness of Bs vs BBs.

In summary, we expect 2018 to be a coupon-clipping year with volatility sources likely to be rates and exogenous shocks (geopolitical, China, US). We also believe that there is high potential for alpha generation from high new issue activities (where we can create returns from coupons and capital appreciation). Furthermore, we enter the ‘season’ (later cycle) where there is significant return potential from “Fallen Angels” (IG companies downgraded to Junk). Such situations can offer interesting investment opportunities as managements’ focus typically shifts from equity upside to the sustainability of the company’s debt structure: during the downgrade-period, bonds typically trade down 10-20 points and trade at significant discounts to par, offering high capital appreciation for investors with bottom-up credit selection focus.
The Norwegian economy concluded 2017 on a much brighter note than it started. Unemployment has fallen markedly and consumer confidence has come back to average. The increase in oil price indicates a positive outlook for the Norwegian economy in 2018. Housing prices have come down, but we anticipate that they will bottom out in the next 4-8 months.

The Norwegian Krone (NOK) weakened in late 2017, which will drive higher inflation in 2018. The tightening labour market is likely to fuel wage growth, but not enough to cause overall inflation to rise significantly. We expect GDP growth to pick up in 2018, driven primarily by private consumption and increased business investment. The housing market downturn will dampen activity in the construction sector, but we believe this will be outweighed by a better outlook in other sectors. Oil investment will probably grow in 2018 and non-oil export-related businesses could see further growth. The positive outlook for the economy prompted Norges Bank to move its interest rate path higher in 2017.

Going into 2018, NOK credit spreads are wide compared to the EUR-market. We expect European credit spreads to remain stable in 2018 – however we foresee more volatility. We remain cautious and will avoid chasing higher yielding issuers to achieve higher carry.

Sweden saw strong economic activity in 2017, supported by the Riksbank’s expansionary monetary policy. Even though GDP growth was stronger than expected early in 2017 and both inflation and inflation expectations have been close to target, we expect expansionary monetary policy to continue at least through the first half of 2018. Employment is at historically high levels; however, we have recently seen signs of a slowdown in the Swedish housing market.

We expect the SEK, which has weakened sharply as a result of this loose policy, to strengthen later in the year as the strong economy forces the Riksbank to raise the repo rate – probably ahead of the ECB.

Both short and long term Government Bonds declined during 2017. The spread between Covered Bonds and Government securities with longer maturities tightened during the year. With an attractive roll down and absolute yield, these bonds contributed to both absolute and relative return during the year. Investment Grade Bonds was by far the best performing asset class in 2017. We aim to keep a fairly high allocation in Covered and Investment Grade Bonds going into 2018, as we find spreads attractive, especially in relation to Government securities. Furthermore, yield curves are steep and generate a good roll down and carry, and a decent risk adjusted return.

Norway
The Norwegian economy concluded 2017 on a much brighter note than it started. Unemployment has fallen markedly and consumer confidence has come back to average. The increase in oil price indicates a positive outlook for the Norwegian economy in 2018. Housing prices have come down, but we anticipate that they will bottom out in the next 4-8 months.

The Norwegian Krone (NOK) weakened in late 2017, which will drive higher inflation in 2018. The tightening labour market is likely to fuel wage growth, but not enough to cause overall inflation to rise significantly. We expect GDP growth to pick up in 2018, driven primarily by private consumption and increased business investment. The housing market downturn will dampen activity in the construction sector, but we believe this will be outweighed by a better outlook in other sectors. Oil investment will probably grow in 2018 and non-oil export-related businesses could see further growth. The positive outlook for the economy prompted Norges Bank to move its interest rate path higher in 2017.

Going into 2018, NOK credit spreads are wide compared to the EUR-market. We expect European credit spreads to remain stable in 2018 – however we foresee more volatility. We remain cautious and will avoid chasing higher yielding issuers to achieve higher carry.

Sweden
Sweden saw strong economic activity in 2017, supported by the Riksbank’s expansionary monetary policy. Even though GDP growth was stronger than expected early in 2017 and both inflation and inflation expectations have been close to target, we expect expansionary monetary policy to continue at least through the first half of 2018. Employment is at historically high levels; however, we have recently seen signs of a slowdown in the Swedish housing market.

We expect the SEK, which has weakened sharply as a result of this loose policy, to strengthen later in the year as the strong economy forces the Riksbank to raise the repo rate – probably ahead of the ECB.

We aim to keep a fairly high allocation in Covered and Investment Grade Bonds going into 2018, as we find spreads attractive, especially in relation to Government securities. Furthermore, yield curves are steep and generate a good roll down and carry, and a decent risk adjusted return.

Norway: Regional Network and Consumer Confidence

Source: Nordea Investment Management AB and Macrobond, as of Nov. 2017

Spread: 5y Covered Bonds vs. 5y Government Bonds

Source: Macrobond, as of 15.12.2017

IG Bonds: Spread Development vs. Stibor/Swap (2-5y tenors)

Source: Nordea Investment Management AB. Date: December 2017. Unless otherwise stated all views expressed are proprietary to Nordea Investment Management AB.
The Asian high yield market rallied in 2017, thanks to the improving economic fundamentals in the region and strong demand from local investors. Looking forward into 2018, we believe that the Asian high yield market will continue to be supported by such factors and perform well. In addition to that, we see an attractive alpha generation opportunity from China’s deleveraging policy and the potential global index inclusion of China’s onshore bond market.

In 2017, the improvement of China’s and other Asian economies’ fundamentals has been a strong support for the Asian high yield market and is likely to extend into 2018. Helped by supply-side reforms and consistent infrastructure investment, both China’s PPI and corporate earnings have moved out of the negative growth area and rebounded strongly in 2017. In addition, China’s real GDP growth stabilised at 6.8% year-on-year in the third quarter, well above the government’s target of 6.5%. In China, we believe that the major investment theme over the next 3 to 5 years for credit investors will be disciplined corporate deleveraging, which favours Chinese credits as a whole. On one hand, China has been taking serious measures to control the further growth of corporate debt since late 2016 (as reflected in the decreasing M2/GDP ratio in the chart), including a slightly tighter monetary policy and stricter regulation on the shadow banking system. On the other hand, ongoing supply-side reforms and infrastructure investment will ensure a stable growth environment for the deleveraging to happen but at a disciplined pace. Thus we could see a good opportunity for investors to identify more and more Chinese high yield credits with improving fundamentals, ongoing deleveraging, but still cheap valuations.

An exciting structural change in the Asian high yield market in 2018 is the potential inclusion of China’s onshore bond market by global bond indices, which could trigger massive capital inflows into China in the next a few years. As China has fully opened its over USD 10 trillion equivalent domestic Renminbi (RMB) bond market to global investors since February 2016, almost all of the “hard” hurdles of international bond index inclusion have already been satisfied. Considering the scale and importance of China’s
Emerging Market Debt

On the back of improving fundamentals such as narrower current account deficits, falling inflation, and growing central bank reserve assets, we expect that EM growth (ex-China) will accelerate from 3.5% in 2017 to 3.8% in 2018, far exceeding our estimated growth of 2.2% from the developed world for the year.

Although macro risks remain on the horizon — e.g. the ongoing removal of developed market monetary stimulus, led by the Federal Reserve’s contracting balance sheet and the prospect of three to four rate hikes in 2018 — some of these concerns may be remnants of the volatility surrounding 2013’s taper tantrum. In fact, during the last sustained Fed hiking cycle between 2004 and 2006, emerging market hard and local currency debt returned 25% and 29%, respectively.

Many idiosyncratic credit stories will continue to unfold in the coming year — Venezuela, Argentina, Brazil, Mexico, Ukraine, and Russia, among others, will undoubtedly be making headlines — yet developments in 2017 again showed that these events can cut two ways, and that the asset class’s resiliency to macro and idiosyncratic events (and the performance of individual country assets) continues to differentiate it. Even though hard currency spreads tightened steadily in 2017, they still remain well wide of 2007’s historical tight of 166 bps, when only one-third of the market carried investment grade credit ratings. At today’s wider spreads, nearly half of the market carries investment grade ratings.

As 2017 ended, we maintained overweights in higher sovereigns and quasi-sovereigns with wider spread levels, and we generally expect spreads to be supported by low developed market rates and solid global growth. Elsewhere in hard currency debt, we expect to continue to seek opportunities to add alpha from exposure to select frontier names. The credit profiles of many of these countries, including, but not limited to, Ecuador, Angola, Ghana, Iraq and Mongolia, are improving with many benefiting from IMF programs.

Turning to local rates, the real yields across a number of countries — Brazil (4.5%), Indonesia (4%), Mexico (3%), and Colombia (2.5%) — remain attractive. We’d note that the exception to our favourable real yield outlook would be certain central and eastern European countries, including Hungary, that carry negative real yields. The performance of the local rates market will undoubtedly be influenced by EMFX, where we also have a constructive outlook for the coming year. When EMFX hit some volatility in the second half of 2017, we noted that during prior selloffs that occurred under similar market conditions — relatively strong global growth and tightening Fed policy — the market declined by a maximum of only 5%. The most recent EMFX selloff, which began in mid-September 2017, represented a 5% decline, and the correction began to reverse course in mid-November.

As we consider the EMD sector more broadly, we believe EMD assets should continue to provide solid opportunities in 2018. In particular, we would point to hard currency assets that trade wide to the major EM hard currency indices and to EM local markets with high real yields and contained inflation. In an environment of a stable-to-declining US dollar, EM currencies stand to benefit as EM economic growth continues to outpace developed markets. Macro and idiosyncratic risks abound, however, making research and security selection crucial components of the investment process.
2017 was another strong year for risk assets. The synchronised expansion in global economic activity continued to provide widespread gains across asset classes. An investor could have blindly thrown a dart at a board of asset classes and most likely land on one with positive returns for the year. The lack of volatility of risk assets across the world was driven largely by accommodative fiscal policy, healthy economic growth and strong consumer sentiment.

At the start of 2017, Mr. Gundlach called for a move lower in the 10YR US Treasury (UST) yield, even though he expected at least two if not three rate hikes during 2017. While many economists were calling for increased 10YR UST yields, data supported the possibility of a move lower. Mr. Gundlach turned out to be correct as 10YR UST yields moved lower and the Fed had three successful rate hikes. Additionally, when the 10YR UST yields began testing the lower bound of their range, Mr. Gundlach openly became bearish on the 10YR UST with the expectation of rising interest rates. The UST yield hit a calendar year low on September 7, 2017 at 2.04% and closed the year on December 29, 2017 at 2.40%.

As we enter 2018, we see little value in the front-end of the UST yield curve and remain tactically bearish on the longer-end of the curve. We believe that 10YR UST yields will remain range bound, but are likely to move higher over the course of the next three months. We believe UST securities should remain a cornerstone in any multi-sector portfolio due to the high quality and liquidity they provide. Furthermore, we continue to sense complacency amongst investors who have enjoyed massive returns since the global financial crisis. The lack of volatility across risk assets and high valuations reminds us to maintain caution around chasing returns. Instead, we continue to favour fixed income portfolios that are well-diversified, actively managed and have a high credit quality bias.

Moving forward, we will continue to keep an eye out for market moving events and catalysts that could create disruption within the markets. Additionally, we continue to sense complacency amongst investors who have enjoyed massive returns since the global financial crisis. The lack of volatility across risk assets and high valuations reminds us to maintain caution around chasing returns. Instead, we continue to favour fixed income portfolios that are well-diversified, actively managed and have a high credit quality bias.
As of November 30th, US corporate credit spreads were compensating investors by less than 1%, on average, above comparable duration US Treasury securities. US Treasuries are widely viewed as among the safest investments in the world. We believe that investors have required a lower credit premium, in part, because the fundamental economic backdrop of the United States has been very durable, supported by low unemployment, healthy wage gains and an overall improvement in consumer wealth. Moreover, global growth outside of the United States appears to be gaining steam, especially in Europe and Japan, along with a number of developing economies.

It is important to note that cheap capital has been made available by a prolonged period of accommodative monetary policy and strong demand from yield-seeking investors. As return on capital has fallen from weakening demographics and rapid advancements in technology, we have observed a steady increase in balance sheet leverage coupled with a similar decrease in interest coverage ratios. Leverage is typically defined by the ratio of a company’s outstanding debt relative to its earnings before interest, taxes, depreciation and amortization charges (or “EBITDA”). Interest coverage ratios, calculated as the company’s EBITDA divided by its interest expense, represents the company’s ability to service its debt obligation from its cash flows. These deteriorating trends have been underway for several years now. As companies have increased their debt load in an effort to fund share buybacks and/or mergers & acquisitions, creditors have been faced with greater systematic as well as greater idiosyncratic risk.

While US corporations have generally enjoyed healthy earnings growth over the past few quarters, we do expect US economic growth to potentially slow over the coming 12 to 18 months as the Federal Reserve further tightens credit conditions. Lower corporate tax rates may extend the current earnings cycle, but headwinds should not go unnoticed. Accordingly, the pace of commercial & industrial loan growth has slowed over the past several months; delinquency rates on credit card receivables have risen and certain borrowers appear to be having greater difficulty servicing their auto loan obligations.

While different risk factors should always be considered when investing, attractive opportunities will present themselves in 2018. As observed in past cycles, credit spreads have stayed below historical averages for an extended period of time. Therefore, adopting a less aggressive targeted risk profile while staying invested is a prudent choice in a low yield environment. Moreover, an active management approach should also benefit as the market continues to differentiate the “winners” from the “losers” over the next year.
The US high yield market finished 2017 on a slightly softer note than it began, with second half returns lower than the first half. Still, the asset class’s performance was solid overall, as the index returned over 7% with minimal bouts of volatility. The market benefitted from a complementary macro backdrop—improving global growth, low unemployment, and low and stable inflation. In the major tax policy overhaul, markets found reason for optimism. More specific to the high yield market, the backdrop of low defaults, solid earnings growth, and stable interest rates have led to spread compression across rating categories.

As we look out to 2018, we anticipate many of the same factors that benefitted the market in 2017 to remain supportive. We anticipate continued solid global GDP growth across regions, with a relatively high probability of the US getting an additional boost from corporate tax cuts. We envisage unemployment remaining at very low levels and believe secular issues in most developed economies will keep inflation contained. All of this leads to a healthy macro backdrop for the US high yield market, which, combined with modest earnings growth, should lead to another year of low default rates.

Given this constructive fundamental view of the asset class, our base case is for high yield’s 2018 returns to be in the 4-6% range. In our opinion, the biggest constraining factor will likely come from tighter monetary policy. A series of Federal Reserve rate hikes will tend to push interest rates higher across the curve. And while rising rates can negatively affect total returns, this is not the biggest driver of total returns. Historically, high yield total returns have been negative only in years of spiking defaults (i.e. recessions or industry corrections). The one exception was 1994, when the Fed surprised the market with 250 basis points of rate hikes.

To the extent our rising rate concerns materialise in 2018, we believe the higher quality sub-segments, most notably BBs — which have the lowest spreads and longest durations — will be most affected. Hence, we prefer B and select CCC credits, and would underweight BBs. The chart illustrates how Caa/Ba spreads are still near the long-run average.

Similar to 2017, we anticipate returns to be driven by idiosyncratic credit risks. While spreads tightened meaningfully in all ratings categories in 2017, we believe lower quality spreads are ripe for security selection, offering reasonable relative value to BBs in a low default environment.

While many of these opportunities are limited to a few specific industries, we believe valuations within these sectors are more attractive than they have been in recent years. Hence, while we are not outright bullish across entire sectors, we do believe there are specific names and securities that are attractive, notably in Telecom, Retail, Health Care/Pharma and Energy.

In summary, we remain constructive on the fundamentals of the high yield market and believe this will lead to historically low but positive returns (4-6%) in a rising rate environment. We continue to look for idiosyncratic opportunities where we believe the market has pushed bond prices down to attractive levels. We believe some of these oversold situations can have a meaningfully positive impact to total returns in 2018 and offset some of the negative influence from rising rates.

Source: Aegon USA Investment Management LLC. Date: December 2017. Unless otherwise stated all views expressed are proprietary to Aegon USA Investment Management, LLC.
US Mortgage Backed Securities

DoubleLine Capital LP
Nordea 1 – US Total Return Bond Fund

- We continue to think securitised products look better positioned than their corporate debt counterparts
- Our expectations from the Fed suggest a more favourable environment for the US Agency MBS market
- Improving fundamentals including rising home prices and declining defaults also support a positive outlook for the Non-Agency RMBS market

The great flattening, the great rebalancing, and the great run-off were amongst the most important themes for securitised products in 2017 – ones we see continuing to move markets in the coming year. Flatter yield and risk premia curves have meant less pickup both in going out in maturity and down in credit. Flows into fixed income continue to be robust in the US – at least partly driven by the desire to rebalance equity allocations into bonds as stock markets continue to march higher. Fed Balance sheet reduction has corresponded with tightening in Agency Mortgages, evidencing the demand for mortgages from other market participants. We continue to think securitised products look better positioned than corporate debt, prefer credit and shorter duration, and think collateral within mortgages remains healthy.

Commercial mortgages shrugged off poor headlines around retail to finish the year as the strongest performing of the securitised space. At this point in the credit cycle, we prefer single asset/single borrower deals when we go down in credit or are looking for more opportunistic investments. Clarity into the collateral backing these deals gives us comfort in more levered portions of the capital structure. As legacy investments run-off and so-called 2.0 deals begin to season we expect more idiosyncratic performance, presenting fresh opportunities within this asset class.

For investors looking to diversify away from residential mortgages, ABS has been a sector of growing significance. Hiccups from some of the first entrants into the consumer lending space grabbed headlines in 2017 as the need for refinements to underwriting processes were uncovered. A broad asset class, ABS typically presents structures short in duration which remains a focus across our view of the mortgage space. While this means these securities were particularly exposed to the flattening of 2017, short average lives, tightening credit spreads and strong collateral performance for senior bonds mitigated the impact of interest rate moves.

Our expectations from the Fed suggest more favourable opportunities in the US Agency Mortgage Backed Securities (Agency MBS) market than we’ve seen in recent years. Net supply in 2018 is expected to be similar to 2017 although the Fed’s actions regarding its balance sheet will result in approximately $170 billion in runoffs. This will likely lead to the highest supply of Agency MBS since the Great Recession. However, we believe the increased supply will be readily absorbed by the market, specifically banks and overseas investors as we have seen so far. A flattening yield curve in 2018 would create a favourable environment for Agency MBS as investors rotate out of bullet Treasury securities into amortising Agency MBS securities: additional carry is worth marginally more as risk free curves flatten. Prepayments are likely to be stable in 2018 in a rising rate environment and a stable housing market.

Non-Agency RMBS tightened with other securitised credit sectors over the past year as investors continue to search for yield. Levels in the space have been supported by a positive technical as new issuance supply has not kept pace with Legacy RMBS run-off. Improving fundamentals, including rising home prices and declining defaults, also support a positive outlook for the sector. In new issue, we continue to favour securitisations backed by non-performing and re-performing loans. Although spreads in the space have come in about 100 bps over the past year, senior front-pay tranches off these deals are still attractive as they offer yields in the low 3% range with a duration of about 1.5 years. Another sector within residual credit that we find attractive is securitisations of non-qualifying mortgages which are loans made to borrowers with either a prior credit event or limited documentation due usually to self-employment. Issuance in the sector more than doubled 2016’s levels and we expect healthy supply into the next year. As we monitor new issue markets for potential opportunities, we will also remain focused on finding value in Legacy RMBS.

Source: DoubleLine Capital LP Date: December 2017. Unless otherwise stated all views expressed are proprietary to DoubleLine Capital LP. DoubleLine has no obligation to provide revised assessments in the event of changed circumstances. While we have gathered this information from sources believed to be reliable, DoubleLine cannot guarantee the accuracy of the information provided. Securities discussed are not recommendations and are presented as examples of issue selection or portfolio management processes. They have been picked for comparison or illustration purposes only. No security presented within is either offered for sale or purchase. DoubleLine reserves the right to change its investment perspective and outlook without notice as market conditions dictate or as additional information becomes available and assumes no duty to update the recipients of this presentation.