

# Market Outlook

July 2011

## The market focus is yet again directed towards Athens

The risk appetite diminished swiftly in June as the Euro zone debt worries (mainly Greece's acute situation) formed darker clouds on the horizon. The weakened US macroeconomic data did not ease the situation and as the Asian markets were also gloomy, the beginning of the month in a few of the western markets was extremely negative. We managed to hedge equity risk quite well in June and raised the equity weights back to a more normal standing in mid June. The equity allocation is lifted to slight overweight and we retain the slight underweight allocation in fixed income. In alternative investments we raise the commodity weights moderately mainly in agricultural commodities and industrial metals, but the total allocation weight is lowered to neutral by decreasing weight in convertible bonds and private equity.

In the debt markets the less risky sovereign debt yields fell as risk appetite diminished. The German 10 year government bonds were traded at levels of 2.83 percent at its lowest in late June. In our Fixed Income portfolio we held an interest rate risk position of three years in mid June but lowered the risk position to around one year by the end of the month. The ECB has signaled that it is on alert regarding inflation and it seems likely that the refinancing rate is raised by 0.25 percentage points.

In corporate bonds and especially in high yield ones, the credit risk premiums were rising in June and many southern European banks' Tier-1 loans were under pressure. The condition of the Italian and Spanish banking sector worries investors and in a larger picture, the success of these countries' bond auctions is under our magnifying glass. Currently the Spanish 10 year government bond is traded at levels of 5.5 percent, which is a quite disturbing level in relation to the long term GDP growth level (about 1%) and unemployment rate, which is around 20%.

The beginning of June was quite weak for the stock markets. The Helsinki stock exchange main index was down at one point by around -11%, which can be regarded as an extremely large monthly fall from a historical perspective. The slightly positive voting result of the Greek parliament regarding the approval of austerity measures got the stock indices to correct their worst losses globally, but still June profits remained at subzero throughout the world. The stock prices of companies that have released profit warnings have been under heavy pressure, which reflects investor sentiment quite well. Companies that have relatively weak pricing power have trouble upholding the current valuation levels and therefore there has been a rough ride. Cost

inflation is looming behind the corner as the raw material prices are at exceptionally high levels in the current business cycle.

Nevertheless, we raise equity investments to slight overweight as a tactical move after forceful selling pressure. In many stock exchanges, the macro turbulence and the repricing of liquidity premiums in case of systemic risk driven market disruptions has dropped stock prices to luring levels. We have received clear buy signals for multiple companies in Finland after a steep decline in June.

Strong fluctuations were also present in the currency markets in June as Greece's situation weakened the Euro against other main currencies. In the US, the negotiations regarding the lifting of the debt ceiling are currently in a stalemate, but the markets are confident that a political agreement can be established.

The fall of oil and industrial metal prices enhanced the general conditions to reach the GDP consensus forecasts. Some agricultural commodities (wheat -24%, corn -13%) experienced extremely large declines in June. As a consequence, we have added the weight of agricultural commodities and industrial metals in our allocation portfolios.

### Market Returns 30.6.2011

Fixed Income	Return 1m	Return 2011	Return 1y
JPM Money Mkt	0,12 %	0,67 %	1,28 %
JPM EMU Govt	-0,43 %	-0,48 %	-1,73 %
Barclays Infl.Linkd	-0,22 %	3,09 %	2,50 %
JPM Credit Index	-0,24 %	1,13 %	1,64 %
JPM High Yield	-0,60 %	5,72 %	14,96 %
JPM GBI EM Divers. (LC)	-0,39 %	-1,56 %	1,10 %
JPM EMBI+ (HC)	1,31 %	5,13 %	11,75 %
Equity Markets	Return 1m	Return 2011	Return 1y
OMXH Mid Cap	-5,46 %	-9,86 %	11,32 %
Euro Stoxx 50	-0,47 %	1,48 %	10,69 %
Stoxx 600	-2,92 %	-1,50 %	12,14 %
S&P 500	-1,83 %	4,99 %	28,13 %
Dow Jones	-1,24 %	7,30 %	27,01 %
Nasdaq	-2,18 %	4,15 %	31,49 %
Nikkei	-0,34 %	-4,04 %	4,62 %
Hang Seng	-5,43 %	-2,61 %	11,27 %
India	1,85 %	-7,57 %	6,47 %
Russia (RTS)	0,96 %	7,71 %	42,36 %
Brazil	-3,43 %	-9,96 %	2,41 %
MSCI Europe	-2,95 %	-1,70 %	11,59 %
MSCI World	-2,92 %	3,41 %	28,32 %
MSCI Emerging Markets	-1,54 %	1,37 %	27,80 %
MSCI Latin America	-0,49 %	-2,87 %	22,64 %
MSCI Eastern Europe	-0,51 %	9,60 %	43,38 %

Alternative Investments	Return 1m	Return 2011	Return 1y
S&P Commodity TR	-5,31 %	4,36 %	26,11 %
Oil (spot)	-7,60 %	2,90 %	19,59 %
Gold (spot)	-2,21 %	6,42 %	19,41 %
HFRX Global HF	-1,88 %	-1,87 %	3,82 %

Foreign exchange	30.6.2011	31.5.2011
EURUSD	1,450	1,440
EURJPY	116,84	117,370
USDJPY	80,56	81,520
EURGBP	0,90	0,875
EURSEK	9,18	8,885
EURNOK	7,81	7,746

Interest rate levels	30.6.2011	31.5.2011
Fed	0,25	0,25
ECB	1,25	1,25
BoJ	0,10	0,10
BoE	0,50	0,50
Euribor 3m	1,55	1,43
Euribor 12m	2,16	2,14
Germany10y	3,03	3,02
iTraxx Europe 5y (IG)	105,67	102,49
iTraxx Crossover 5y (HY)	394,91	369,67

# Fixed Income

## Past events

The fear of the impact of the Greece parliament's negative voting result regarding the austerity measures escalated on the markets by driving investors to less risky government bonds and the flight to quality could also be seen well by the euro zone banking industry risk measures. Some British banks transferred assets from the euros system to sterling denominated markets and forceful selling pressure could be observed in the US money market funds in June. The 2 year US government bond sank to 0.4% and the yield of the 10 year German government bond visited just under 3%. The inflation swaps (inflation priced my markets) have been sliding down due to calming commodity prices and clearly fading economic activity.

*A fear of systemic market disruption put pressure on the interest rates*

Currently the 5 year inflation swaps are traded at levels of 2.02% for the Eurozone and at 2.41% for the US. In corporate bonds, the credit risk premiums widened notably in June and especially the high yield ones were under selling pressure. At the index level, the European high yield dropped by -0.6% in June. In the beginning of the month, companies stormed to emission markets as they wanted to ensure their financing before a possible escalation of systemic risks on the markets. In late June, one could observe illiquid trading in corporate bonds at times. As the trading volumes remained at low levels, the market movements tended to be quite forceful.

## Current situation

The focus of the markets were directed towards the Parliament house in Athens as a possible negative voting outcome on the austerity measures would have prevented Greece from obtaining its fifth portion (12 billion) of the rescue package of 110 billion, which was sealed last year. Greece has to pay 3 billion worth of coupons in July to the debtors and the country's cash reserves would have been depleted without the fifth aid slice. Still the EU/IMF/ECB triplet needs to come to an agreement regarding the delivery of the next loan tranche, but this decision should come a bit easier than in Athens end. The positive voting outcomes in Greece (austerity measures+ its implementation) launched a frenzy on the stock markets as risky assets were amassed in the end of the month. The long period challenges of Greek solvency have not disappeared per se, but in the short term the uncertainty factor considering systemic risk has been swept away. The French have planned a "Brady bond"-type solution for the Greek

*Greece said "yes"*

bonds owned by French banks. In such a solution, 70% of the bond nominals maturing at 2014 would be reinvested (voluntary extension of debt maturities). For this 70%, 50 percentage points of it would go with 30 years maturity with a coupon of 5.5% plus a possible 2.5% additional coupon linked to Greece's GDP growth. The remaining 20 percentage points would go to a "special fund", with an objective of obtaining a good credit rating for the fund so that it could be used as collateral. This model resembles closely the US tailor made Brady Bonds that were used to save Latin America. Also the GDP linked bonds have been used in e.g. Argentina with good results in the long term. At the moment it seems that the credit rating agencies (except Fitch) would not define a voluntary debt extension as a credit event and hence the technical, and especially for the derivatives markets meaningful credit default event would not occur.

## The future

In addition to the sovereign debt problems that are shaking Europe, the situation in the US has been a topic of conversation recently. The country needs to raise its law determined debt ceiling or otherwise a technical default lies ahead and the government expenditures need to be heavily cut down due to lack of money. The credit rating agencies have emphasized that this is not a laughing matter and expect that a political common ground can be found. Currently the quarrel between the parties has reached epic proportions. In long term, also the US needs to increase its taxes and make balancing efforts in its fiscal policy as the US government debt just barely meets the criteria for an AAA-rating in light of the current figures. S&P has commented that they might issue a negative outlook for the US if stalling is done in implementing fiscal adjustment measures. From a helicopter perspective it seems that great challenges lie ahead for USA, as in light of current knowledge it seems that regardless of extremely low interest rates, massive expansive fiscal policy in

*The US has its own worries to think about*

junction with two QE-packages of the central bank (buying back government bonds from the markets) have not been enough to achieve a turnaround on the employment rate nor in GDP growth. In the big picture, the massively expansive fiscal and monetary politics that we have witnessed has increased the asset prices of risky asset classes globally. Surely the conditions for companies to create new jobs and to invest are more favorable with the stimulation of economy, but there is a price tag to pay. Especially the recovery of the labor markets has been sluggish when considering the extent of the stimulation. The consensus forecasts for the US GDP growth are estimated to be 2.5% this year and 3% the following year. The slower growth period that is currently on hand might recover to be slightly better during autumn as the supply chains of a few industrial sectors return to their normal rhythm after the Japanese natural disaster. However, the rapid drop of the purchasing manager indices close to levels of 50 indicates clearly that the economic activity is more moderate than during the beginning of the year.

# Equities

## Past events

In June, we saw stock markets under strong selling pressure. Under the most pressure were the Scandinavian exchanges, and Finland's -10% Year to date return at index levels is a fact. Our Finland Dividend basket has performed very well with the year to date return being +5.06% (30.6.2011). Successful share picks and active adjusting of equity weights (in June the net equity weight varied between +4% and +105%) within the frames of absolute return, has borne fruit. Also with our allocation products, we succeeded in the timing of adjusting our equity weights. As for our mandate and combination baskets, we increased equity weights back to a neutral-like situation with the help of index futures (Euro Stoxx50 at 2711 level). The selling pressure has been very visible in the returns by sectors within indices.

Defensive sectors have outperformed general indices (eg. healthcare). Another interesting matter is that small companies in the U.S. have clearly outperformed the general index, but in Europe the situation is just the opposite. Finland's underperformance against Sweden's stock exchange (-10% vs -4% year to date) and against Europe (Stoxx 600 -1.5%) is a brutal example of a cyclical stock exchange experiencing strong selling, for example by foreign investors under selling pressure. In our opinion, sharp drops in share prices have partly been excessive, and therefore during this downfall, we have purchased more domestic names such as Konecranes and UPM. Our timing for increasing equity weights really hit the mark this time, as share prices spiked when the turbulence in Greece took a timeout at the end of the month.

*Stock markets providing a bumpy ride*

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## Current situation

In the short term, during the last week of the month, stock markets had the time and room to rally, when Greece voted in favor of enabling new bailout packages. Bank shares were on a good run, although in a longer view, their underperformance against indices is evident. Of the present holders of Greece's 330 billion euro debt, Greek banks hold 45 billion euros, other Greek investors 45 billion euros, ECB 47 billion euros, European banks 38 billion euros and other foreign investors 150 billion euros. It now seems that on top of the current 110 billion euro bailout package, Greece would be receiving an additional 80 billion euros, 30% from IMF and 70% from Eurozone countries and the private sector. In regards to funds being

raised through privatization, we remain cautious, as the selling of Government owned property in the current market at "good levels" is difficult. In any case, one milestone that has justly kept markets worried has been passed, as Greece itself finally took initiative in implementing new austerity measures. Strong macro turbulence will certainly continue around Greece and the challenges the U.S. will face in raising their debt ceiling at the end of July, which will affect willingness to take risk before the beginning of the Q2 earnings season.

*One less concern in systemic risk, in the short term...*

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## The future

We have noticed a fading momentum in profit margins in the markets, and earlier in the spring-summer, the profit margin momentum was already down in Nordic exchanges. Now the same has happened to Stoxx 600 companies in Europe. The underlying profit fundamentals driving the stock market, when considering revenues, are still rising (analysts together raise revenue forecasts), but as for profit margins, the sentiment is souring. Food producer price inflation is estimated at 7-9% for the ongoing year, which clearly indicates pressure. Second quar-

ter earnings will play the guardian role for the rest of the year, as macro fundamentals are weakening in Asia (China's latest PMI at 50.9 level), as well as in Europe and the U.S., and at the same time profit margins are under pressure. Despite strong factors of uncertainty, we are raising our equity weights to moderate overweight, and we are primarily maintaining a long position in our equity baskets. We see value in the share prices of companies that in our estimates are charged with a potential of 20% gains, and that have been strongly affected by the drama in Greece.

*A lot at stake for the Q2-earningsperiod*

# Alternative investments

## Alternative Investments

In private equities we are lowering our allocation weight back to underweight. Also our weight in convertible bonds will drop by one slot to neutral as we make room for direct equities.

As for hedge funds, we are maintaining a neutral weight. In fact, in the beginning of July, we have invested in a starting fund that invests in Asian equities and aims for absolute returns, and the portfolio managers have a very good return history from similar strategies. We also expect this fund to succeed. Our combination baskets and Emerging Opportunities basket made subscriptions to the fund.

## Real Estate

In terms of real estate, we are not making any changes. We are maintaining our neutral allocation weight. U.S. housing market figures have been anything but encouraging. The recovery of prices in many market areas have turned into another downfall as the mass of unsold property is still large.

## Commodities

As for commodities, we are increasing our weight to moderate overweight. We are aiming our increased overweight towards agricultural commodities, as in some cases the prices dropped heavily in June. We are also opening our position in industrial metals (heaviest weight in copper and aluminum). With the correction of oil prices to the level of 90\$/barrel and low interest rate levels, together they spiced up economic activity especially from a consumers point of view in the U.S., where tax rates eg. gasoline, are generally lower than elsewhere.

Market outlook (change to previous month)	Monthly recommendations 6/2008 - 7/2011*																																								
	6	7	8	9	10	11	12	1	2	3	4	5	6	7	8	9	10	11	12	1	2	3	4	5	6	7	8	9	10	11	12	1	2	3	4	5	6	7			
<b>Fixed Income: Moderate underweight</b>	(=)	4	4	4	4	3	4	4	4	4	4	4	3	3	3	4	3	3	3	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2			
Europe money markets: Underweight	(=)	5	5	5	5	5	5	5	4	3	2	2	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1			
Europe government bonds: Underweight	(=)	2	2	3	4	4	3	3	1	1	2	2	1	2	2	3	2	2	2	1	1	2	2	2	1	1	2	2	2	1	1	1	1	2	2	1	1	1	1		
Investment Grade: Neutral	(=)	4	3	3	3	3	3	4	5	5	5	5	5	5	5	5	4	4	4	4	4	4	4	4	4	3	3	3	3	3	3	3	3	3	3	3	3	3	3		
High Yield and Structured products: Moderate underweight	(=)	4	4	4	3	3	3	3	3	3	3	3	4	3	3	3	2	3	3	3	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4		
Emerging market bonds: Moderate overweight	(=)	4	5	5	4	4	4	4	4	4	3	3	3	2	2	2	3	3	3	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4		
Inflation: Neutral	(-)	4	3	3	3	3	4	4	3	2	2	2	3	3	2	3	2	2	1	2	2	1	2	3	2	2	2	3	3	3	3	3	3	3	3	3	3	3	3		
<b>Equities: Moderate overweight</b>	(+)	1	2	2	2	2	1	3	3	2	2	4	4	3	3	4	4	3	4	5	5	5	3	5	4	4	4	3	3	4	3	3	3	3	3	3	3	3	4		
USA: Neutral	(=)	3	3	2	2	2	2	3	3	3	4	3	3	3	4	4	3	3	4	4	4	4	4	5	4	3	2	1	3	3	4	4	4	4	4	4	4	3	3		
Europe: Neutral	(=)	1	1	2	1	1	1	1	2	2	2	2	3	3	3	2	2	3	3	2	2	2	2	1	2	3	4	5	3	3	2	2	3	3	3	2	3	3	2	3	
Japan: Moderate underweight	(=)	2	2	2	2	2	1	2	2	1	1	1	1	1	1	2	2	2	1	1	1	1	1	2	2	2	2	2	2	1	2	2	2	2	2	2	2	2	2	2	
Emerging Market Equities: Moderate overweight	(=)	3	3	2	2	2	3	3	4	4	3	4	4	5	4	4	4	3	4	5	4	5	5	5	5	5	5	5	5	5	4	3	3	3	3	4	4	4	4	4	
<b>Alternative Investments: Neutral</b>	(-)	3	3	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	
Private Equity: Underweight	(-)	3	2	2	2	2	3	3	2	2	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	2	2	3	3	3	3	3	3	3	2	1	
Real Estate: Neutral	(=)	1	1	1	1	1	1	2	2	2	1	1	1	3	3	3	4	4	4	4	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	
Hedge Funds: Neutral	(=)	5	5	5	5	5	3	3	3	3	3	3	4	4	4	4	3	4	3	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	3	3	3	
Convertible Bonds: Neutral	(-)												4	4	4	3	2	2	2	3	3	3	3	2	3	3	3	2	2	3	3	3	3	3	3	3	3	4	4	3	
Commodities: Moderate overweight	(+)	3	3	3	1	1	3	4	4	4	4	4	4	3	2	3	3	4	3	3	4	4	4	4	4	4	4	4	4	4	5	5	5	5	5	5	4	4	3	3	4

\* Explanations: 1 = Underweight, 2 = Moderate underweight, 3 = Neutral, 4 = Moderate overweight, 5 = Overweight

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