

# Market Outlook

August 2011

## Economic growth decelerating – Systemic risk worries have surfaced again

The jovial holiday month of July contained extremely large macro economic events and ground shaking incidents that impact the very footing of western nations. We entered the month with slight overweight in equities, which we truncated quite swiftly in our positions. As we have headed to August, we lower the equity weight back to neutral in our allocation, but we remain tactically ready to change the weights drastically, if the market pricing provides grounds for it. The stock prices of many single companies have been beaten down quickly from the top levels this year and we are beginning to see good value and opportunities in e.g. cyclical stocks. However, the clear fading of economic growth keeps us on our toes, as the market sentiment on equity markets is quite fragile now due to the aforementioned, combined with a horrific fear element regarding the ability of countries' to cope with their debts, while at least partially acute liquidity crises are also present. The fixed income allocation weight is retained at slight underweight and the stance in alternative investments is kept at neutral.

The Greek insolvency situation could be mended in the final meters after a colossal political rumba, but still the true Eurozone question marks Italy and Spain have experienced strong widening pressures of government bond yields. Both of the major Eurozone debtors' 10-year government bond yields are over 6% and the current levels are not far from the levels of Ireland, Portugal and Greece that forced these countries to throw in the towel

regarding availability of market funding. We have been repeating our view that Italy and Spain are surely going to be attacked on the market as one of the biggest touchstones will be the asymmetric ending event of the chain of events. We anticipate that the Eurozone is going to be under tremendous pressure in leadership and decision making concerning these countries.

We increased the amount of interest rate risk (duration) in our Fixed Income basket as the risk appetite departed from the markets, but as we have entered to August, we remain attentive on also this position. Our long continued allocation preference for Scandinavian debt issuers is bearing fruits as e.g. Scandinavian banks have clearly relatively over performed their European peer group. The liabilities of a few Italian banks have even inverted (short term yields are higher than long term), which reflects strong current uncertainty towards Italian bank sector.

In July, the global stock markets dropped heavily apart from a few exceptions (e.g. Indonesia). The second quarter earnings period started decently in the US. Around 75% of US companies beat Q2 expectations (however they had been cut down in June), whereas in Europe and particularly in Finland the amount of earnings disappointments has been more numerous. Altogether the stock prices of companies with earnings disappointments and earnings warnings have been punished strongly. We slashed the equity weights in our portfolios twice in mid July and especially the market

movement down in the end of the month was forceful. The proper freefall began in the beginning of August. We lower our equity weight recommendation from slight overweight to neutral, but we are ready to react if the market movements provide a reason to do so. The stock prices of many Finnish companies have been thrashed at such a pace that we see over 50% upside for some companies in our valuation models. However, the current macro news stream from various governments, the global economic growth figures and the swift exiting of risk appetite give reason to carefully assess when to paddle countercurrent.

Raw material prices remain at quite high levels in our view, when considering the weakening of current macro data and we have decreased our holdings in especially some agricultural commodities. We lower commodities back to neutral position in our allocation. Otherwise we keep our allocation weights untouched for alternative investments.

On the currency markets, a lot is happening outside Euro and US dollar. The Swiss Franc is enjoying strong demand as risk appetite is fading. Also the Australian and New Zealand's dollars have been getting stronger against both the US dollar and the Euro. The EURUSD has remained at an astonishingly small variation range during the summer. The first interventions were seen already in Yen and in Switzerland "verbal interventions" have been utilized in order to weaken the Franc.

### Market Returns 29.7.2011

Fixed Income	Return 1m	Return 2011	Return 1y
JPM Money Mkt	0,14 %	0,80 %	1,34 %
JPM EMU Govt	0,14 %	-0,34 %	-2,53 %
Barclays Infl.Linkd	-1,22 %	1,82 %	0,20 %
JPM Credit Index	1,33 %	2,47 %	2,26 %
JPM High Yield	-0,16 %	5,55 %	10,86 %
JPM GBI EM Divers. (LC)	2,27 %	0,68 %	4,22 %
JPM EMBI+ (HC)	2,05 %	7,29 %	9,26 %

Equity Markets	Return 1m	Return 2011	Return 1y
OMXH Mid Cap	-8,31 %	-17,35 %	-4,17 %
Euro Stoxx 50	-6,25 %	-4,87 %	-2,62 %
Stoxx 600	-2,79 %	-4,25 %	3,88 %
S&P 500	-2,15 %	2,73 %	17,31 %
Dow Jones	-2,18 %	4,96 %	16,03 %
Nasdaq	-0,62 %	3,51 %	22,25 %
Nikkei	-0,17 %	-3,87 %	3,10 %
Hang Seng	0,19 %	-2,43 %	6,71 %
India	-3,44 %	-10,75 %	1,84 %
Russia (RTS)	3,06 %	11,00 %	32,80 %
Brazil	-5,74 %	-15,12 %	-12,87 %
MSCI Europe	-2,61 %	-4,27 %	3,64 %
MSCI World	-2,28 %	1,05 %	14,69 %
MSCI Emerging Markets	-0,44 %	0,92 %	17,45 %
MSCI Latin America	-3,50 %	-6,27 %	5,81 %
MSCI Eastern Europe	0,35 %	9,99 %	27,68 %

Alternative Investments	Return 1m	Return 2011	Return 1y
S&P Commodity TR	2,44 %	6,90 %	22,30 %
Oil (spot)	-0,27 %	3,20 %	13,96 %
Gold (spot)	8,39 %	15,51 %	36,71 %
HFRX Global HF	-0,04 %	-1,55 %	2,97 %

Foreign exchange	29.7.2011	30.6.2011
EURUSD	1,440	1,450
EURJPY	110,54	116,840
USDJPY	76,76	80,560
EURGBP	0,88	0,903
EURSEK	9,04	9,177
EURNOK	7,75	7,813

Interest rate levels		
Fed	0,25	0,25
ECB	1,50	1,25
BoJ	0,10	0,10
BoE	0,50	0,50
Euribor 3m	1,61	1,55
Euribor 12m	2,18	2,16
Germany10y	2,54	3,03
iTraxx Europe 5y (IG)	116,58	105,67
iTraxx Crossover 5y (HY)	438,00	394,91

# Fixed Income

## Past events

*German interest rates falling – Italian and Spanish interest rates up*

In July, Greece narrowly accepted the new austerity package in Athens and some sort of political agreement was reached between Germany and France. Yet in the end several questions remain, for example, how will the private sector actually take part? Out of four optional alternatives in the rolling over of bonds (extending the maturity) and write-downs, there is already some uncertainty, yet the arm wrestling between the ECB and large EU-countries regarding the losses for the private sector was brought to an end. Greek bonds will be rolled over at a loss of around 20%. The European Financial Stability Facility (EFSF) will be allowed to purchase government bonds in the future as well, but only according to ECB guidelines. All in all, after a massive political struggle, behind the scenes an even larger bomb is ticking as Italy's and Spain's debts begin to widen. For a long time now, we have maintained this is an unavoidable scenario, partly due to the asymmetry in the chain of events. At the moment there is no natural mega sized clientele that could compensate for the strong selling pressure from bank and investor portfolios in the short-term. The ECB has

purchased 16% of Greece's debt in the secondary market, and in the case of Italy and Spain a corresponding percentage figure would mean EUR 300 billion, of which the ESFS would already have spent the lion's share of its capacity. An increase in the capacity of the ESFS and the launch of Euro bonds are next on the agenda. On a year level, Italy and Spain have issued a total worth of around EUR 600 billion in government bonds, and therefore, markets closing on their part would cause much pain to the harmony of the Euro zone. In corporate bonds, our strategy to focus on Finnish and Scandinavian bonds has borne fruit. Especially Scandinavian banks (perhaps with the exception of Denmark) have held up relatively well in July's turbulence. We raised the interest rate risk within our Fixed Income basket in July, but prevailing rates going into August (German 2-year government bond 1.05%, 5-year 1.60% and 10-year 2.42%) do not compensate for prevailing inflation expectations (Euro zone 5-year inflation swap). For this reason we must actively amend our interest rate risk level constantly.

## Current situation

*Italy and Spain "too big to fail"?*

Yields of lower risk government bonds in the EU (Germany, Holland, Finland) declined sharply (nearly 0.5% in the 10-year sector) as investors parked their assets in these bonds. Respectively, the reason for this was the strong movement in Italy's and Spain's government bonds, which at the moment are trading at a level of over 6%. The Italian government bond market is the world's third largest after the US and Japan, and together with Spain they pose a significant central risk over the Euro zone. The possibility of these two countries being cut off from market funding, would pose a great problem for the entire Euro zone. In order to cover Italy's debt of about EUR 1800 billion, it would be enough on its own to eat up a year's equivalent of Germany's GDP, and the sheer size of this is enough to raise stakes in the market. Italy's and Spain's fundamentals look slightly different as Spain's government debt is around 70% of its GDP. Still as Spain's banking sector is on the rocky side, the symbiosis between it and the government remains strong. Italy's government debt is greater (120% of GDP), but its corresponding savings bank problem (Cajas) is not on the same scale with Spain's. Also Italy's public sector's finance deficit is smaller than Spain's,

however it has left its financial needs on the back end this year and the amount of debt to roll over is substantially greater than Spain's. We will monitor the performance of these bond auctions, but already prevailing rates are driving towards forced sales and rising debt collateral. In the beginning of August, Berlusconi is already in talks with the ECB for plans to balance Italy's budget by the year 2013, for which in return the ECB could begin purchasing Italian government bonds in the secondary market, thus offering support to an already fragile situation. We still do not hold any government bonds issued by these European countries that are in trouble, nor any of their corporate bonds. In corporate bonds, credit risk premiums in high yield names were on the rise during the month of July, however, a panic such as the one witnessed in government bond markets was not seen. All in all, the balance structure of companies seems to be in good shape, and their cash reserves are at an adequate level. The situation lives on, but at the moment the aggregate level of cash held by the US is USD 1,9 billion (comp. US federal deficit USD 1.5 billion).

## The future

*U.S. rating faces downgrade*

The last thing the markets wanted to contemplate going into August in addition to the macro and European situation, was the completely unnecessary drama witnessed in raising the US debt ceiling. Confidence in the capability of the US government to hold serious issues under control shattered. In the end, the voting behavior of the democrats and the republicans indicates a problem in handling domestic policy. Federal revenues are on a weak base, as the individual income tax rate is around 10% and turning around the decision to cut taxes by the previous administration does not seem possible. Cut in the public sector seem unavoidable and no additional help to stimulate the economic growth can be expected from that side either. The similar situation regarding the fiscal stimulus occurs even in Europe and in China. This severe state of affairs starts to slowly become evident in the markets and therefore the ending of Fed's QE2 -package is pressing the market massively. Downgrade on the U.S. from AAA-level to AA+ (with negative outlook) is now a fact. The U.S. government stated quickly the false S&P calculations but it was too late. The investment sentiment is furious as the least the market was expected were the broad consensus

regarding the cuts and increases in taxes. Currently the alarming situation leads further to a broad downgrade in the municipal market which is already in a weak state. Even the biggest individual debt investor China shows some concerns towards the U.S. Japan is the second biggest creditor. The fall in German and U.S. government bonds continuously reflects the safe heaven behavior but changes are to occur even here. For example American bank Bank of NY Mellon announced it will in future claim 0.13% fee for the deposits in this low interest rate environment to restrain the cash being parked into the deposit accounts. Ultra-low/negative interest rates are once again reality in the U.S. It is noteworthy that the interest levels remain in significantly low levels and inflation expectations are neither especially high (5 year inflation swap 2.14% in the U.S.) despite the Fed's massive and unconventional measures. We have not made changes into our allocation regarding the fixed income investments. High yield name spreads are becoming wider as we anticipated due to utmost illiquid trading and we expect this to continue in August. We maintain our high yield allocation of moderate underweight.

# Equities

## Past events

### *Chilly ride in the equity markets continued*

The selling pressure gained momentum in July, and in the beginning of August the floor crumbled big time. Worries about whether the system can be kept intact started to accentuate as the government bond yields of Italy and Spain rose over 6% levels. The banking sector in Europe has been under heavy selling pressure and especially in Italy stocks have experienced a free fall at times. Our slight overweight allocation was quickly turned in our positioning in early July as we hedged our portfolios even drastically at times. Still, the July profits of our investment baskets were mainly on the negative side, which is not pleasing overall. However, we managed to perform quite well compared to the general development of the markets. Cyclical stocks were beaten senseless, but our evidence does not support the view that only foreign investors were folding their holdings in Finnish cyclical stocks in late July and early August. In the US, value stocks have fallen clearly more than the aggregate index, which impacts our America baskets performance slightly. Nevertheless, we have also there performed quite well compared to markets. Banks are beginning to be these

value stocks in USA (e.g the P/B of BoA which equals price/book value is 0,5!). In Europe, the value stocks have fared pretty well compared to aggregate indices in July. Another observation from USA is that the overperformance of small cap stocks that has continued a while is starting to bend, but on the other hand Nasdaq (and technology sector in general) has performed quite well compared to S&P 500. An indicator of a turning point in the economic cycle has also been the clear underperformance of industrial companies. Workshops, airlines, i.a GE and various weapon industry companies (budget dependent) have lost their standings in relation to the aggregate index. In Finland, the underperformance of OMXH against Sweden and Eurostoxx 50-index continues. In the beginning of August, the sky was falling down in the Finnish markets and even good earnings results seemed irrelevant under the selling pressure (For example Nokian Renkaat and Metso published positive interim results combined with a surprisingly strong order book).

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## Current situation

### *Strong capitulation in the market*

The trading volumes on the equity markets intensified to be monstrous during the first week of August. On Friday in the US derivatives markets, the trading volumes for the first 45 minutes were equivalent to trading volumes of a regular day in July. Parties on the markets battle with high stakes and it seems that at least some kind of capitulation has occurred from the seller perspective. Strong overreactions are at hand as companies that are most vulnerable to economic cycles have been thrashed mercilessly. In USA, the analyst consensus expectations still forecast 14% earnings growth for companies in the S&P 500-index for this year (vs 2010) and even 11% growth for 2012. If a full blown economic stand still (which the stock market is pricing on 5.8.2011) were to

occur, the consensus forecasts for earnings growth and turnover growth are utopia. At the same time, the possibly stabilizing macro environment and coordinated interventions of governments and central banks accompanied by credible political linings could provide a chance for a major upward recoil, as the current pricing especially for the most cyclical companies is very low. The forward looking P/E for S&P 500 index is currently 12.0 The downgrading of the US government pressurizes portfolios of banks and simultaneously the market counterparties are forced to weigh the collateral requirements of derivative market counterparties.

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## The future

### *Importance to actively manage the equity weights emphasized*

At the moment, investing in the stock markets from a fundamental viewpoint is quite challenging as the market is surrounded by strong volatility. Global GDP growth forecasts and company specific earnings forecasts are forcefully questioned every day, which is apt to create uncertainty on the markets. Yet again active management of equity weight has proved to be a good choice and we have been able to partially hedge from the stock decline. In our view, the situation is not going to be more straightforward in the long term, but the active equity risk management does provide a clear advantage to a "buy and forget"-strategy. We have kept very low equity weights at times, i.a Finland Dividend-basket has been in negative numbers and it is now under 20%, and it has been a while since the underlying straight

equity investments have seemed inexpensive. However, one must remain especially observative as many risk scenarios are about to realize on the markets that were considered as "tail events" a few months ago. When the markets are viewed from a fundamental viewpoint, the margin pressure due to increasing costs (risen costs of labor, risen raw material costs) that we already noticed in spring seems to continue. After all, a strong correction in multiple expansion which means paying higher prices for the same results, has been achieved as systemic risks are mounted in the prices of stocks. We are going to make considerable changes in the equity weights during these challenging times (in August), even though our view in this analysis regarding stocks is retained at neutral in this analysis.

# Alternative investments

## Alternative Investments

In private equities we are maintaining our allocation weight in underweight. Also our weight in convertible bonds remains in neutral weight. The convertible market proved again the functioning of its in-built hedging element under the equity dip July.

As for hedge funds, we are maintaining a neutral weight. In general the hedge fund performance in long/short only - managers especially has been fairly modest this year the central equity hedge fund - index performance being currently -9% from the year start. However, our hedge fund investment to Asia has performed fairly well in July.

## Real Estate

In terms of real estate, we are not making any changes. We are maintaining our neutral allocation weight.

## Commodities

As for commodities, we are decreasing our weight one notch to neutral. We lessened the load of agricultural ETF in our Mandate portfolios after a strong hike in July. In the commodity market further corrections to lower levels can expect if macro news continues to deteriorate with the similar pace that has been seen after June. Prices in metals are continuously high compared to dips in PMI -figures (purchasing managers indices).

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

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

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