

## Europe patches up confidence—Situation in Italy even gloomier

The performance of riskier asset classes was strong in October. Especially in the U.S., the stock market gains were more consistent, but in Europe a strong rally was seen at the beginning of the month and right at the end of the month when EU leaders revealed their "Grand Plan," which raised the sentiment for investors. We have maintained very low equity weights, as we are not yet convinced about the solution models for the debt problems, especially with the lack of concrete specifics. Also the current equities earnings forecasts, especially in the U.S., are in our opinion still far too optimistic. Right at the beginning of November, we received a quick reminder of this, as riskier asset classes took a quick dive.

### Allocation Weights

**-Fixed Income:** We maintain a neutral weight in fixed income.

**-Equities:** We maintain our equities at moderate underweight

**-Alternative Investments:** We maintain a neutral weight.

### Italy under surveillance as the debt crisis continues.

The spreads between Euro government bond yields continued to widen. The French 10-year yield is already above 1.2% against Germany, but the most acute problem lies in Italy. The Italian 10-year yield climbed to 6.3% which is the Euro zone all-time high. At these levels, Greece, Ireland and Portugal had to throw in the towel on new bond auctions. At the end of the month, Italy managed to issue a new 10-year bond at a 6.6% yield level, but the market's concern over Italy's entire debt burden and ability of rolling its debt at these levels is understandable. In our fixed income portfolios, we do not hold Southern European government bonds or corporate bonds issued in these countries. We are focusing on corporate bonds issued in Finland and the Scandinavian region. The further widening of credit risk premiums in corporate bonds eased in October.

### Equities at underweight as the debt crisis continues and earnings forecasts in the U.S. remain overly optimistic

In stock markets, key indices gained strongly in October, whereas gains in the U.S. were more steady. In Europe, we witnessed a very strong rally at the beginning of the month and a similar one following the EU summit at the

end of the month. We have maintained our low equity weights, as we are not too convinced over the proposed bailout package to help tackle and put an end to Europe's debt problems. Furthermore, U.S. corporate earnings forecasts for next year and 2013 are still relatively high. Markets expect earnings to grow +12% next year and a further +12% during 2013. Profit margins and their forecasts will most probably feel downward pressure, as forecasts are currently historically high. In Finland and Scandinavia, we have already seen several companies announce profit warnings as well as cut forecasts, and all in all the earnings forecasts in Finnish markets are beginning to reach realistic levels.

### Price of oil soars despite diminishing economic growth

In October raw materials corrected their losses from August and September as the correlation of risk taking willingness was high. The price of oil (WTI) climbed from 75\$/barrel to almost 95 dollars in October and industrial metals ascended strongly as well. The pricing of European convertible bonds is beginning to look interesting due to the sharp rise in corporate credit risk premiums. This is also supported by the fairly sharp fall in stock markets from the beginning of the year as well as the rising fluctuation of share prices.

### Markets Returns 31.10.2011

Fixed Income	Return 1m	Return 2011	Return 1y
JPM Money Mkt	0,16 %	1,30 %	1,55 %
JPM EMU Govt	-2,04 %	0,70 %	-2,44 %
Barclays Infl. Linked	-2,50 %	-1,34 %	-4,21 %
JPM Credit Index	0,62 %	3,52 %	2,14 %
JPM High Yield	7,53 %	3,26 %	3,90 %
JPM GBI EM Divers. (LC)	1,56 %	-1,21 %	1,17 %
JPM EMBI+ (HC)	4,42 %	8,44 %	3,96 %
Equity Markets	Return 1m	Return 2011	Return 1y
OMXH Mid Cap	8,83 %	-23,70 %	-18,69 %
Euro Stoxx 50	9,43 %	-15,03 %	-16,16 %
Stoxx 600	7,65 %	-12,11 %	-8,45 %
S&P 500	10,77 %	-0,36 %	5,92 %
Dow Jones	9,54 %	3,33 %	7,52 %
Nasdaq	11,14 %	0,80 %	7,06 %
Nikkei	3,31 %	-12,13 %	-2,33 %
Hang Seng	12,92 %	-13,63 %	-13,99 %
India	7,60 %	-13,16 %	-11,62 %
Russia (RTS)	16,57 %	-11,69 %	-1,50 %
Brazil	11,49 %	-15,82 %	-17,45 %
MSCI Europe	7,77 %	-11,86 %	-8,38 %
MSCI World	11,32 %	-6,67 %	-2,86 %
MSCI Emerging Markets	13,25 %	-11,10 %	-7,72 %
MSCI Latin America	17,07 %	-14,86 %	-13,36 %
MSCI Eastern Europe	16,60 %	-13,09 %	-7,33 %

Juhani Lehtonen

Alternative Investments	Return 1m	Return 2011	Return 1y
S&P Commodity TR	9,75 %	1,14 %	10,08 %
Oil (spot)	17,47 %	0,50 %	8,54 %
Gold (spot)	6,34 %	22,16 %	26,13 %
HFRX Global HF	2,97 %	-5,13 %	-3,55 %
Foreign exchange	31.10.2011	30.9.2011	
EURUSD	1,386	1,339	
EURJPY	108,33	103,120	
USDJPY	78,17	77,060	
EURGBP	0,86	0,859	
EURSEK	9,01	9,202	
EURNOK	7,70	7,852	
Interest rate levels			
Fed	0,25	0,25	
ECB	1,50	1,50	
BoJ	0,10	0,10	
BoE	0,50	0,50	
Euribor 3m	1,59	1,55	
Euribor 12m	2,12	2,08	
Germany10y	2,03	1,89	
iTraxx Europe 5y (IG)	162,19	201,98	
iTraxx Crossover 5y (HY)	659,77	839,05	

# Fixed Income

## Past events

*Bandaging the open wounds*

At the end of October, EU leaders managed to patch up a public statement regarding the next procedures in governing the acute threat of the European debt problem, after all too familiar discordance. Firstly, the unanimous decision was made to bolster the capital ratio of European banks from the current 5% to 9% requirement (so called Tier 1-ratio) which in an optimistic scenario means raising capital of around 106 billion euros from markets, national governments or as a last resort from the EFSF. As for Scandinavian banks, the situation is not so problematic, as they are already close to those levels or beyond. Southern European banks will however have to consider the possibility of selling parts of their business or loan portfolios as well as liquidating their assets. The customer margins of banks will rise as whole, which will in the long run affect the velocity of money circulation and lead to the premise of economic growth. On the other hand, the recapitalization of banks is a vital condition as the Euro zone attempts to avoid the debt crisis from spreading. Secondly, EU leaders reached an agreement with the

private sector on a 50% haircut of Greek debt. The threat of a full blown default convinced the representatives of the financial sector to fall in, and discussions on how credit rating agencies will treat this are now ongoing. Greek credit default swaps (CDS) would trigger a payout, if acceptance was involuntary. We may still face this situation if there is a lack of voluntary acceptance from the private sector. It is still unclear what the remaining debt burden is from the investors point of view. Thirdly, an outlined agreement was reached to increase the capacity of the EFSF to participate in secondary markets through leveraging. The purpose of the EFSF is to provide an investor who purchases newly issued bonds with a sort of insurance that it would take on 20% of possible losses. This way it could leverage its capacity by 4-5 times. Details can be expected by the end of November. There is a fear of "two government bond markets" beginning to form, which would lead to owners of older bonds to sell off their portfolios. This seems to be the case with Italy for example.

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## Current situation

*Fierce volatility continues in credit risk premiums*

The fluctuation of asset classes and instruments has increased significantly which can be seen in our own Mandatum Life Risk-index. Increased volatility has a derivative effect on the real economy outside of markets, as financial players will consider making investment decisions as well as smaller scale consumer decisions in light of future confidence. Should views be very uncertain, the tendency to prolong considerable decisions is far greater. This is the current situation, and this can especially be seen in the most recent figures of consumer confidence and purchasing manager indices. The Italian PMI printed out the bottom figures of the cycle 43.3, which can be considered as alarmingly weak. France and Spain are also falling harder than Germany for example. The strong become stronger

and the weak become weaker—Our theme continues to prove itself. The channels to raise new capital have opened for the strongest banks, as in October a few new floating bonds were issued in the markets. The market for Southern European banks to borrow money without collateral is at a standstill. Europe's strongest bank, AAA-rated Rabobank, was the first bank in a long time to execute a Tier1-issue, as demand in the U.S. dollar market was considerable. The EFSF has had to hold off its plan for issuing bonds, which will not raise the already fragile attitudes towards, the "Grand Plan."

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## The future

*How will Italy survive?*

Italy's future within the secondary markets is more than a thousand dollar question at the moment. The country's yields have hit levels (2-year 5.2% level and 10-year 6.2%) that have the market paralyzed for a reason. Italy's need to roll their debt for next year is 298 billion euros. All in all, Italy's debt is 1.8 trillion euros, thus the full paralysis of the world's third biggest bond market would be a very difficult problem to solve. The share prices of Italian and other European banks that own Italian bonds have already been pushed down, and the question remains, how will these debts be valued in balance sheets. In the U.S., the first financial institute (MF Global) to hold bonds of Euro zone border states collapsed. We do not recommend investing in government bonds issued by European countries in crisis

despite tempting yield levels, as the threat of major selling pressure from investor portfolios is real. Greece's proposal to hold a referendum on the most recent bailout package (really a question of remaining in the Euro zone) will cause great uncertainty for the rest of the year. Papandreou's possible resignation and Greece's domestic politics are considerably driving risk taking willingness at the moment. Despite the politics, we currently see value in corporate bonds. Despite the somewhat fierce volatility in credit risk premiums, the current pricing is far more tempting compared to the yield profile of lower risk government bonds (Germany). As for bonds issued by banks, we will continue to focus only on larger Scandinavian banks.

# Equities

## Past events

*Markets excited over equity risk*

In stock markets, we generally saw brisk rallies during October, which were fueled by the return of a more positive sentiment. Fundamentally, nothing earth shattering was gained, as the earnings season in the U.S. is advancing according to the script. The offerings of the EU summit had leaked into the markets, and the only actual piece of news was that an agreement had been reached. In October we did not want to take substantial risk in equity markets, which has now during the first days of November borne fruit. Over all, the drastically cut U.S. macro data figures were slightly better than expected which allowed risk taking willingness to recover. The U.S. GDP consensus forecasts have dropped significantly over the past 3 months. At the moment,

the GDP growth rate for 2012 is at a 2% level, whereas in June it was at a 2.9% level. Also in the Euro Zone, the GDP is expected to grow by 0.7% next year, whereas during the summer the growth was estimated at 1.6%. In light of purchasing manager index figures (Euro zone PMI 47.1 and ISM in the U.S. 50.8), we can see that confidence in the future is diminishing despite earnings growth of companies being at moderate levels. In stock markets, volatility has remained high, and for now a quick recovery is nowhere in sight.

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## Current situation

*Q3 earnings season as expected*

The third quarter earnings season of this year is drawing to a close. Generally the earnings season has advanced as expected (2/3 of companies beat forecasts) in the U.S. and slightly worse in Europe. In Finland we saw a number profit warnings and over all the outlook for Finnish companies has been traditionally weak with the exception of a few bright spots. With Outotec, we saw an all time high order book, which illustrates a strong cycle in the mining industry. Times have been tough for the paper industry as well as for other cyclical companies as profit warnings have been commonplace. Generally during Q3, warehouse levels have been on the rise and lower components of confidence index figures support this as well (new orders vs. inventory). In Finland, earnings forecasts for Helsinki's stock exchange have been cut by -16% during the last 3 months. Respectively, the U.S. markets are still expecting 12% growth for next year (this year 2011 S&P 500 EPS-forecast 94\$). Earnings forecasts for next year have only been cut by 2%. At this point, the gap between the

GDP growth and earnings growth is beginning to diverge. Company earnings account for a large share of the GDP, and should future outlook weaken at all, it is not impossible say that the end result of the S&P 500-index for next year could for example be 75\$. This would mean 1125 index points with a long 20 year price to earnings ratio average (P/E) of 15. In 2008 and 2009 S&P 500 companies made a profit of 58\$, which with a P/E ratio of 15 would mean an index figure of 870 points for the S&P500-index. The EBIT margin (earnings before interest and taxes) average in the U.S. during the last 10 years has been around 12%. The consensus forecast now expects margins to improve next year to 14.8% and to 15.3% in 2013 (S&P 500). So it seems that current market expectations for margins are quite challenging as well. Therefore, in light of these factors within this environment of high volatility and weakening confidence, we are maintaining a low equity weight.

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## The future

*Low equity weights still justified*

When quantitatively examining analyst forecast modifications (raises vs. cuts) we can see that Europe is at around a -0.7 level (out of 100 companies earnings forecasts have been raised for 70 companies and cut for 30). This revised ratio figure is at the same level as at the bottom of the 2008 financial crisis. Despite this, when examining the modified forecasts from an absolute point of view, the modifications are surprisingly subtle. The corresponding revised ratio figure in the U.S. is -0.45 (bottom of 2008 around -0.8 level). In practice, this means that analysts have begun cutting their forecasts, but very carefully. Companies have given very foggy estimates for the end of 2011, whereas most companies have refrained from saying anything at all about next year. Actually, only Caterpillar and Adidas have been able to give estimates of their figures for 2012. In

the strenuous car industry, MAN and Scania have reported that they will cut production by 10-15% from the beginning of November. We can clearly see that the weak dollar is favoring U.S. exporters against their European competitors for example. This is clear especially in the cyclical engineering works industry. All in all we have positioned ourselves in stock markets with low equity weights and we will take advantage of the opportunity to make purchases when the time is right. At the moment, the weakening macro economy and the European political uncertainty regarding solution models for the debt crisis, give enough reason not to root for risk taking willingness. In any case, we are well aware that may Finnish and Scandinavian companies are at tempting price levels, should they perform according to the normal cycle.

# Alternative Investments

## Alternative investments

In private equities we are not making any allocation changes and we are maintaining our weight in underweight. We are raising our convertible bonds weight by one slot to neutral. The convertible bonds market offers interesting potential for profit, for example in the form of increased credit risk premiums and equity volatility. As for hedge funds our weight remains in neutral. The equity long/short hedge funds have performed poorly this year due to increased volatility and the lack of any trends. In addition to this, the quick falls and rises in risk taking

willingness, even at daily levels, has complicated the situation for hedge funds. On the other hand so called multistrategy funds have performed moderately well this year. Our fixed income hedge fund has driven the risk level down, but has still turned positive yield this year.

## Commodities

In commodities, we have not made significant changes to our allocation. Our Global Food basket has a small long position in corn, but even so we are maintaining a low risk level. All in all, volatility is expected to grow in the commodities markets, as markets adjust to more moderate growth figures in China resulting from a weaker demand environment in the western world (cf. copper price volatility).

Market outlook (change to previous month)		Monthly recommendations 5/2009 - 11/2011*																															
		5	6	7	8	9	10	11	12	1	2	3	4	5	6	7	8	9	10	11	12												
Fixed Income: Neutral	(=)	3	3	3	4	3	3	3	3	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2	3	3	3		
Europe money markets: Moderate underweight	(=)	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	1	2	2	2	
Europe government bonds: Underweight	(=)	1	2	2	3	2	2	2	2	1	1	2	2	2	1	1	1	1	1	1	1	1	1	2	2	1	1	1	1	1	1		
Investment Grade: Overweight	(=)	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	4	5	5		
High Yield and Structured products: Moderate overweight	(=)	4	3	3	3	2	3	3	3	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	3	2	2	2	2	3	4	4	
Emerging market bonds: Moderate underweight	(=)	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	3	2	2	
Inflation: Neutral	(=)	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	3	3	3	
Equities: Moderate underweight	(=)	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	3	4	3	2	2	2
USA: Moderate underweight	(+)	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	3	1	2	
Europe: Moderate overweight	(-)	3	3	3	2	2	3	3	2	2	2	2	2	1	2	3	4	5	3	3	2	2	3	3	3	2	3	3	3	3	5	4	
Japan: Moderate underweight	(=)	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	2	2	2	
Emerging Market Equities: Neutral	(=)	4	5	5	4	4	4	3	4	4	5	4	5	5	5	5	5	5	5	5	4	3	3	3	4	4	4	4	4	3	3		
Alternative Investments: Neutral	(=)	2	2	2	2	2	2	2	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	4	4	4	4	4	3	3	3	3
Private Equity: Underweight	(=)	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	1	1	1	
Real Estate: Neutral	(=)	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	3	3	3	3	
Hedge Funds: Neutral	(=)	4	4	4	4	3	4	3	4	4	4	4	5	4	4	4	4	4	4	4	4	4	4	3	3	3	3	3	3	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	4	4	4	4	3	3	2	3	
Commodities: Moderate underweight	(=)	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	3	2	2	

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

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