

# Market Outlook

## The Euro crisis heats up

A strong fluctuation was seen in the markets in the beginning of November and during the second half of the month sales pressure gained the upper hand. We increased our equity weights in our composed baskets and mandates when the market hit the bottom and, in our allocation, the equity weight is rising to neutral level. The greatest coordinated measure since 2008 was undertaken by international central banks (FED, ECB, BoJ, BoE etc.) when the price of interbank lending (OIS) was lowered from 1% to 0.5%. This was immediately passed on to the operational conditions of commercial banks in the area of dollar and euro funding. The situation in the markets is growing tense and the problems have reached international proportions. Nonetheless, we are now exploiting market pricing to our advantage and lifted our equity weight tactically.

### Allocation Weights

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

**-Equities:** We lift our equities from moderate underweight to neutral weight.

**-Alternative Investments:** We maintain a neutral weight and, within alternative investments, raise commodities to neutral.

### The Euro zone crisis is culminating in Italy and Spain

Our allocations in the interest rate markets are mostly kept unchanged. We have avoided European government bonds and carry on in the same way. The risk we are willing to take is lying in Scandinavian financial and corporate bonds instead. The core of the European debt problems depends upon Italy and Spain. In November the markets of Italian government bonds were stagnant at times and it was practically the ECB support purchases keeping the interest markets alive. The Italian bond rates being above 7% is unsustainable and the savings procedures carried out by Prime Minister Mario Monti's new government are further cutting the growth potential for 2012. Still, every measure possible has to be undertaken to restore the confidence in the markets in order to secure market funding for Italy. The borrowing rates for banks in the Euro zone are already higher than during the turbulence of 2008-2009. The situation is very challenging for the time being.

### Decline in share prices in November offered short-term buying opportunities

A strong turbulence in share markets continued in November. The companies have not

given any significant signals after the earnings season and the analysts anticipate exceptionally positive earnings growth in USA next year and 2013. In Europe the forecasts are a bit more realistic and in Scandinavia they even seem cheap. This reflects the whole situation in the markets. Despite the strong volatility we raised the equity weight on our mandate and combined baskets at the end of November. The equities are raised in our allocation to neutral weight. The change in willingness to take risks reflects the extreme tense circumstances in the area of politics when Europe is falling into a recession. We find fast tactical shifts in equity risk reasonable.

### Unrest in Middle East raises the oil price

When it comes to commodities, the price of crude oil and distillments have kept on rising strongly. The price of WTI crude oil was \$75 in October but now it is over \$100. Riots in Middle East and the events in Iran are keeping the price firm. This is seen in the consumer behavior of the households with a delay. The prices of agricultural commodities have instead gone down. The index dropped over -8%. We have not yet increased the weight of agricultural commodities in our portfolios.

**Juhani Lehtonen**, director  
Investment Management

### Markets Returns 30.11.2011

Fixed Income	Return 1m	Return 2011	Return 1y
JPM Money Mkt	0,19 %	1,50 %	1,61 %
JPM EMU Govt	-2,82 %	-2,15 %	-2,62 %
Barcleys Infl.Linked	-4,89 %	-6,17 %	-5,53 %
JPM Credit Index	-2,33 %	1,10 %	0,88 %
JPM High Yield	-3,98 %	-0,86 %	1,26 %
JPM GBI EM Divers. (LC)	0,08 %	-1,13 %	-0,55 %
JPM EMBI+ (HC)	-0,47 %	7,93 %	7,12 %

Equity Markets	Return 1m	Return 2011	Return 1y
OMXH Mid Cap	-2,07 %	-25,29 %	-19,14 %
Euro Stoxx 50	-2,30 %	-16,98 %	-12,09 %
Stoxx 600	-1,40 %	-13,33 %	-8,31 %
S&P 500	-0,51 %	-0,87 %	5,63 %
Dow Jones	0,76 %	4,11 %	9,45 %
Nasdaq	-2,39 %	-1,60 %	4,89 %
Nikkei	-6,16 %	-17,54 %	-15,12 %
Hang Seng	-9,44 %	-21,78 %	-21,81 %
India	-8,93 %	-20,92 %	-17,41 %
Russia (RTS)	-1,44 %	-12,96 %	-3,54 %
Brazil	-2,51 %	-17,94 %	-16,00 %
MSCI Europe	-1,42 %	-13,11 %	-8,24 %
MSCI World	-1,15 %	-7,74 %	-1,82 %
MSCI Emerging Markets	-6,66 %	-17,03 %	-11,54 %
MSCI Latin America	-6,19 %	-20,13 %	-15,70 %
MSCI Eastern Europe	-1,77 %	-14,63 %	-5,81 %

Alternative Investments	Return 1m	Return 2011	Return 1y
S&P Commodity TR	1,42 %	2,57 %	10,44 %
Oil (spot)	7,82 %	8,23 %	15,29 %
Gold (spot)	1,33 %	23,94 %	24,99 %
HFRX Global HF	-0,87 %	-7,89 %	-6,13 %

Foreign exchange	30.11.2011	31.10.2011
EURUSD	1,345	1,386
EURJPY	104,37	108,33
USDJPY	77,62	78,17
EURGBP	0,86	0,86
EURSEK	9,09	9,01
EURNOK	7,76	7,70

Interest rate levels		
Fed	0,25	0,25
ECB	1,25	1,50
BoJ	0,10	0,10
BoE	0,50	0,50
Euribor 3m	1,47	1,59
Euribor 12m	2,04	2,12
Germany10y	2,28	2,03
iTraxx Europe 5y (IG)	185,06	162,19
iTraxx Crossover 5y (HY)	757,36	659,77

Source: Bloomberg

# Fixed Income

## Past events

*Time is running short*

The pace of market movements in the core of the European debt crisis is constantly beating the pace of decision making by the politicians. A week after the EU summit had again made decisions about the European Financial Stability Facility, the idea of a leveraged EFSF (4-5 times) had already expired. The greater plans in respect of EFSF were undermined when French debt widened relative to Germany. Finally, the stagnation in the Italian government bond market in November proved the need for change in EU's tool box. In practice the Italian bond markets (1800 billion euro) are due to their extent a thermometer for the confidence on the Eurozone. At worst, in tandem with Spain they are able to form such a storm center that central banks has to do their utmost to assure market functionality. This creates the core of the problem. ECB's mandate does not include a right to buy government bonds directly from the emissions. It has only got a restricted capacity to support secondary markets.

ECB has announced that in order to have a more widespread sphere of operations ECB's mandate in the EU treaty has to be reformed. Germany has made it clear that it is against the reform. It is seen morally hazardous when central banks are purchasing government bonds, since those having power through political organs would know that as the last resort the central bank would have the possibility to annul the debt. Furthermore, the Germans are outstandingly afraid of accelerating inflation after own experiences with hyperinflation. The European Commission and the Euro Group have stated that the circumstances are extremely dangerous for the credibility and confidence of the euro. The Germans are only now creating automatic sanctions for those countries who fail to meet the budget rules given in the Stability and Growth Pact. So called Eurobonds are facing resistance from the German side as well as from other strong union members.

## Current situation

*Weak foundations for European growth prospects*

At the moment, growth expectations are readily adjusted in Europe. Three months ago the consensus estimates showed +1.4% growth in the Euro area but now we stand at +0.5%. There is a chance that even this estimate is too optimistic. Southern euro countries are heading for recession with an accelerating speed and the tighter fiscal policy does not feed the growth. The purchasing manager indexes have dropped and the latest figures from the service sector are cruel. In Spain the index in relation to the service sector wound up being 36.8 points in November which clearly refers to recession. It is the lowest value in the Euro area for the time being. When it comes to industry it is Italy hitting the bottom with 43 points. Under the command of the new president ECB made in short order the first cuts in interest rates (1.25%) in November and we are expecting to see a new cut after the summit at the beginning of December. The euro has maintained its value relatively well despite the strong turbulence on the Eurozone. This is reinforced by investment flow to Europe (euro investors closing foreign positions). The same phenomenon was experienced in the core of the

financial crisis in USA when the value of the dollar rose remarkably when local investors closed foreign positions. We anticipate that the euro has downside pressure if ECB cuts the interest rate to 1% and starts stronger support measures on government bond markets through secondary market actions. Weakening the euro would create competitive advantage against the exporters in the dollar area who have benefited from the weak dollar already for a while. In our view there are some interesting corporate bonds on the markets. We retain investment grade corporate bonds in an overweight position and slight overweight in high yield bonds. We have a rather high weight in Scandinavia. The price of bank risk has risen substantially and at the moment we stand at higher profit levels that after the collapse of Lehman 2008. The banking sector in Europe paralyzes if Italia and Spain would not anymore receive market funding. Yet, we see the value in Scandinavian banks' UT2 bonds (the first call options are surely used without exceptions) and selected Tier1-bonds.

## The future

*Vague forecasts in USA*

The latest economic data from USA have been relatively encouraging. The employment rate is gradually rising and consumption recovering. Even the savings rate has experienced a slight decline. The large companies are benefiting from the weak dollar in the form of competitive advantage but small companies do not have as enjoyable circumstances. The majority of them are expecting sales to drop from this year's figures in 2012. The government position is not threatened by the markets in the USA at the moment, even though the discussion on cutting costs in the budget automatically is tense. USA is still receiving loan with low interest from the markets. The inflation prospects have also collapsed (inflation-swap levels: U.S. 5-year 2.16%, EU 5-year 1.85%) on the both sides of the Atlantic Ocean as a result of recent turbulence on the markets. Growth expectations have also been lowered in USA, but

rather moderately. Consensus estimates are predicting +2.2% GDP growth in USA. Inflation prospects are slowing down also in the USA although the oil price has been climbing during the fall. It seems that the inflation pressures are easing off globally, even in the EM countries. The latest figures from China indicate that the government would soon have possibilities to apply even more stimulative fiscal and monetary policy. This would encourage willingness to risk taking. China gave already one signal of this when the Chinese central bank lowered the reserve requirements in the turn of the month. We anticipate that the environment for the interest markets remains volatile and the credit risk premiums is affected mainly by political news. The interest rates are starting to approach the bottom. One indication was the failed auction of German 10-year government bonds.

# Equities

## Past events

The earnings season of the third quarter 2011 came to an end without greater news. U.S. companies met mostly the earnings estimates and the attention was quickly directed to systematic risk themes in Europe. Exceptionally strong volatility and high correlations between stock exchanges indicate how nervous the investment environment is at the moment. Emerging markets have not been immune to the turn of the markets. China and Brazil being in the front, the stock exchanges in emerging countries have rapidly decreased in value in November (MSCI EM -9.9% in November). Greece, Spain, France and Finland were instead the

*Strong price volatility*

weakest stock exchanges in the Euro area in November. When it comes to different sectors, it was information technology which over performed (+10.3%) the general index (Stoxx600 -6.9%) in November. The banking and finance sector continued to be unsuccessful in November by sinking -14.3%. The energy sector is supported by the high oil price and thus, over performed the general index, as did also the consumer service sector. We maintained low equity weights in November but at the end of the month we loaded some more equities to our portfolios.

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## Current situation

Despite the strong correlation between the equity markets significant differences can be seen in the forward looking valuations. In the U.S. the investment bank strategists have slowly decreased earnings growth estimates along the lower GDP estimates. Still the equity analysts who only follow individual companies are expecting fairly good earnings for next year (difference on average over 10%). Forecasts include earnings growth of +16% in 2011, +10% in 2012 and even +12% in 2013. We find this estimate too positive but at current it looks unlikely that these forecasts would be revised quickly this year, rather in coming months. In addition the earnings margins are expected to be extremely positive (+15% in 2012), which we also find as a too optimistic scenario compared to current GDP estimates. We anticipate that margins on average remain at current levels or even decrease. This will further keep earnings per share growth moderate. In Europe

*Significant differences in valuations.*

the forecasts are slightly more realistic. At the moment the earnings growth is estimated to be +3% in 2011, +10% in 2012 and +10% in 2013. In the beginning of this year the market was still forecasting +15% growth rate for the year 2011 both in Europe and in the U.S. The possible drift into recession in Europe is already partly included in prices. This has led that the companies in Finland among other countries, are now activating their commercial paper programs to prepare for the strengthened financing environment. All in all we anticipate that earnings growth estimates will be revised also in the U.S. but the actual schedule remains a big question mark. Forward looking P/E estimate ratio of 12 would give for S&P 500 -index figure 1275 result of 106 dollars which is market consensus for the next year. In case of declining cycle of the earnings estimate even P/E ratio of 12 is too high.

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## The future

We anticipate that the equity markets will remain unstable also towards the end of this year. During the first week of December the market and the credit rating agencies started to be quite annoyed and the difficult decisions pushed through were a big touchstone for the politicians in Europe. S&P considers also dropping the credit ratings of some AAA-countries if decision-making in Europe remains as difficult as it has been so far. Also the credit rating of the EFSF is under pressure, if the triple-A countries face a downgrade. The macro news flow will be in focus in December. Also a central theme in the market will be the so called January effect, where the investors who seek to win the market index adjust their positions according the indices in the beginning of the year. It is possible that this movement can already be seen in December. We antici-

*Price fluctuation remains strong.*

pate that besides the macro data also cost development will be followed more carefully next year. Employment costs are higher than core inflation in many countries and also energy prices increase continuously. Pressure on earnings margins can come across fast if demand weakens as fast as the purchasing manager indices indicate. Another interesting theme is the situation in the developing markets. In China the market stimulation has already been started and taxes hindering equity market flow have also been removed in Brazil and interest rates have been decreased. Valuations are relatively low in EM countries and political measures will further direct interest to EM exchanges among international investors.

# Alternative Investments

## Alternative investments

In private equities we are not making any allocation changes and we are maintaining our allocation in underweight. Also the allocation weight in convertible bonds remains neutral.

For hedge funds our weight remains neutral. Our fixed income hedge fund has maintained its positive yield year to date despite the turbulent market environment. In general the equity long/short hedge funds have performed poorly this year (by the end of November -19% YTD).

## Commodities

In commodities, we raise our allocation weight one notch into neutral weight. We are following especially the agricultural side after the recent fall in prices. In November the soft commodities over performed clearly the other risky asset classes. Industrial metals in copper's wake have been under some pressure due to the Chinese demand situation and recent prints from the Chinese PMI (48) do not offer strong support for a strong increase. Therefore the increase in the allocation weight is more of tactical nature.

In crude oil we follow the development of the WTI-Brent spread with interest, as it has tightened significantly.

Market outlook (change to previous month)	Monthly recommendations 6/2009-12/2011*																																
	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		
<b>Fixed Income: Neutral</b>	(=)	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	3	3	3	3		
Europe money markets: Moderate underweight	(=)	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	2		
Europe government bonds: Underweight	(=)	2	2	3	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	1	1		
Investment grade: Overweight	(=)	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	5		
High yield and structured products: Moderate overweight	(=)	3	3	3	2	3	3	3	4	4	4	4	4	4	4	4	4	4	4	4	4	3	3	2	2	2	2	2	3	4	4	4	
Emerging market bonds: Moderate underweight	(=)	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	2	
Inflation: Neutral	(=)	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	3	
<b>Equities: Neutral</b>	(+)	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	3
USA: Moderate underweight	(=)	3	3	4	4	3	3	4	4	4	4	5	4	3	2	1	3	3	4	4	4	4	4	4	3	3	3	3	1	2	2	2	
Europe: Moderate overweight	(=)	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	5	4	4	4	4	
Japan: Moderate underweight	(=)	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	2	2
Emerging markets: Neutral	(=)	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	3	3	
<b>Alternative Investments: Neutral</b>	(=)	2	2	2	2	2	2	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	4	4	4	4	4	3	3	3	3	3	3
Private equity: Underweight	(=)	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	1	1
Real estate: Neutral	(=)	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	3	3
Hedge funds: Neutral	(=)	4	4	4	3	4	3	4	4	4	5	5	4	4	4	4	4	4	4	4	4	4	4	3	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	3	3	3	2	3	3	3
Commodities: Neutral	(+)	3	2	3	3	4	3	3	4	3	4	4	4	4	4	5	5	5	5	5	4	4	3	3	3	4	3	3	2	2	2	3	

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

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