MANDATUM LIFE

Market Outlook

January 2012

New Year—Same Themes

The end of the year 2011 was relatively peaceful when volumes and trading activity fell significantly at the end of December. No new flavors were added into Euro crisis during December and government bond markets stayed stable on the Euro zone. Rapid additions in the liquidity of three year loans (1 % interest rate) for commercial banks run by ECB were accepted in a positive atmosphere. Thus, the financial situation for banks was secured over the turn of the year. We are not going to make changes in our recommended allocations at the beginning of the year.

Allocation Weights

-Fixed Income: We maintain a neutral weight in fixed income.
-Equities: We added equity weight in our portfolios on December 20 and the neutral equity weight is maintained also in January.
-Alternative Investments: The changes in weights in alternative investments are kept small in January and, for now, we are not going to make changes in our commodity weights.

The debt crisis has caused a lack of confidence between Euro banks
We do not hold any government bonds from the crisis burden countries in our position and the majority of our investments in fixed income are allocated to corporate bonds of Finnish and other Scandinavian companies. The yield levels of Italian government bonds with 10-year maturity fell near 6% in December but by the end of the month the levels came close to 7%. Banks in the Euro zone have had difficulties collecting money from the markets at the end of the year and at the beginning the ongoing year the banks are still relying on covered bond markets (collateral loans, such as mortgage pools). The addition in liquidity in December launched by ECB has not caused much more than massive increase in deposits back at ECB (record-breaking 455 billion euro). The confidence between banks stands far from normal.

Companies are expected to announce profit warnings before the earnings season
Thanks to strong rise at the end of the month, the main indices ended up near the levels experienced at the beginning of December. We added equity risk in our mandate and combined portfolios after the mid-December (in high risk, from 40% to 60%) and we are aiming at almost neutral equity risk also in January. We are expecting a high number of profit warnings before companies are announcing the results for 2011. We anticipate that the guidance given is still undistinguished, since the growing uncertainty during the last quarter of the year has its reflections on the short term views given by companies´ management. When it comes to profit expectations, the current situation has not changed in December. The equity analysts´ eagerness to lower estimations was somewhat diminished when purchase manager indices of companies proved to be stable when nearing the bottom values reached during the fall. We continue to make even rather big tactical changes in equity allocations at the beginning of the year.

Unrest in Middle East raises the oil price and increases the volatility of other commodities
The oil price has been kept high due to disturbances in Middle East. The western countries are limiting the import of Iranian oil as a protest against Iran´s defiance on the neighboring area. At the same time the volatility of other commodity prices has grown. We are not making any changes in our commodity allocations for now. As a whole, the weight changes made in alternative investment baskets are kept low. When it comes to currencies, euro has kept on weakening against the currencies of the biggest trading partners. Amongst other things, the British pound, Swedish crown, US dollar and Japanese yen have gained remarkably against euro

Juhani Lehtonen, director
Investment Management

Markets Returns 30.12.2011

Fixed Income	Return 1m	Return 2011	Return 1y
JPM Money Mkt	0,19 %	1,69 %	1,69 %
JPM EMU Govt	4,02 %	1,79 %	1,79 %
Barcleys Infl.Linked	5,58 %	-0,93 %	-0,93 %
JPM Credit Index	2,52 %	3,65 %	3,65 %
JPM High Yield	2,59 %	1,71 %	1,71 %
JPM GBI EM Divers. (LC)	2,17 %	1,02 %	1,02 %
JPM EMBI+ (HC)	1,27 %	9,30 %	9,30 %

Equity Markets	Return 1m	Return 2011	Return 1y
OMXH Mid Cap	-3,64 %	-28,00 %	-28,00 %
Euro Stoxx 50	-0,60 %	-17,47 %	-17,47 %
Stoxx 600	1,86 %	-11,72 %	-11,72 %
S&P 500	0,85 %	-0,02 %	-0,02 %
Dow Jones	1,43 %	5,60 %	5,60 %
Nasdaq	-0,58 %	-2,17 %	-2,17 %
Nikkei	0,25 %	-17,34 %	-17,34 %
Hang Seng	2,47 %	-19,85 %	-19,85 %
India	-4,15 %	-24,20 %	-24,20 %
Russia (RTS)	-10,32 %	-21,94 %	-21,94 %
Brazil	-0,21 %	-18,11 %	-18,11 %
MSCI Europe	2,04 %	-11,33 %	-11,33 %
MSCI World	-2,04 %	-9,62 %	-9,62 %
MSCI Emerging Markets	-1,21 %	-18,03 %	-18,03 %
MSCI Latin America	-1,86 %	-21,61 %	-21,61 %
MSCI Eastern Europe	-9,87 %	-23,05 %	-23,05 %

Alternative Investments	Return 1m	Return 2011	Return 1y
S&P Commodity TR	-2,11 %	0,41 %	0,41 %
Oil (spot)	-1,62 %	6,58 %	6,50 %
Gold (spot)	-10,48 %	10,95 %	10,38 %
HFRX Global HF	-0,47 %	-8,33 %	-8,33 %

Foreign exchange	30.12.2011	30.11.2011
EURUSD	1,296	1,345
EURJPY	99,66	104,37
USDJPY	76,91	77,62
EURGBP	0,83	0,86
EURSEK	8,92	9,09
EURNOK	7,74	7,76
Interest rate levels		
Fed	0,25	0,25
ECB	1,00	1,25
BoJ	0,10	0,10
BoE	0,50	0,50
Euribor 3m	1,36	1,47
Euribor 12m	1,95	2,04
Germany10y	1,83	2,28
iTraxx Europe 5y (IG)	173,00	185,06
iTraxx Crossover 5y (HY)	754,80	757,36

Source: Bloomberg

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Fixed Income

Past events

ECB gave a helping hand

European central bank renewed its tools in December by offering banks 489 billion euro up to three years without cap by 1% interest rate. After the old operations had matured the net amount of new liquidity to the banks is approx. 190 billion euro. In addition ECB alleviated collaterals for liability to receive its funding. Over 500 banks participated in this operation which eased the financing for banks. The financing for market price has increased in autumn. Credit spreads of banks' senior bonds have risen to 2.8% levels and equity side the 5-year maturities are priced in derivative market to 5%. The situation is in many ways worse than after Lehman default in 2008 which illustrates clearly the seriousness of the current situation. One back thought from ECB is surely to reset banks to consider the attractiveness of the so called carry investments (borrow at 1%, invest in 6% for example to Italy) instead of central bank having to need to continue to support Euro zone through direct government bond purchases. The size of ECB's balance sheet has increased over 25% under Q4 and now the central bank has moved towards quantitative easing (QE) following the foot steps of inflation hawkish Trichet. For the present the commercial banks in Euro zone have not been eager to increase the amount of European government bonds but instead parked the money they borrowed from the central bank back into ECB with the interest of 0.25%. We monitor carefully how long this situation will last. ECB has also continued its quiet intervention on the secondary bond market. Due to central bank intervention Italy's 10-year bond stayed under 7% in December.

Current situation

Recession waiting behind the door

The growth forecast for Euro zone has been revised in the market further down towards the year-end and at the moment the consensus expects -0.2% for the ongoing year. Still in October the market expected a growth of +1.1%. Handling of the debt crisis has stopped and this has damaged the confidence permanently both among private household as well as for the companies which had already experienced canceling of orders. Inflation is expected to set around 2% this year (according to ECB mandate) and the unemployment rate to rise over 10% in Euro zone. In Germany the industrial orders fell drastically (-4.8%) in November which reflects the present situation where the confidence measures still overestimate the realized industrial development for the rest of the year. Such the inflation forecasts and nominal interest levels in Germany are in line with the recession forecast. One year German government bond trades on the negative side and two year bond yields 0.18%. From the industry's point of view some light in the tunnel can be seen in the weakening euro which will enhance with a delay the export competitiveness compared to American companies that have long time had advantage of the weak dollar. The households profit from low interest rate levels (euribors remain relatively calm despite the bank situation) supporting the loan costs but the increase in unemployment rate will decelerate retail demand in the beginning of the year. The governments' ability to boost domestic demand by expansive fiscal policy is not anymore realistic at the volume experienced in 2008-2009 and the cut will be implemented in the whole Euro zone. From this point of view we see that ECB should boost even further its reflationary monetary policy. Euro is likely to continue its weakening in the beginning of the year despite the strong positioning of the market.

The future

FED likely to start also inflation targeting

The recent notes from FED have been in line with Bernanke's new alignment. The US central bank has emphasized its openness by announcing a long-term view on the interest rate level. We expect the next move from FED to be a similar guidance on inflation target in the beginning of autumn. At current the communication of inflation target would provide FED more room combined with the long-term interest rate targets as the central bank's toolbox is starting to get empty. So called QE3 –package (government bond purchases from the market) still remains as an alternative if further recovery means are needed. Currently it seems that the housing market is stabilizing and also employment figures are slowly recovering. Still the unemployment rate remains high and the smaller companies have not detected the long-awaited turn in the economy. Consensus awaits the US economy to grow by +2.1% after the weak third quarter (1.8%) and slightly better Q4 (approx. 3.4%). The US government bond market has been boosted by the positive investment flow despite the more moderate purchasing eagerness by the Asian central banks thanks to Euro debt crisis. The interest rate levels are very low in the US and no changes are likely to occur anytime soon. In Euro zone the focus relies continuously on the corporate bond market in which on average 80% of the total yield level derives clearly from the increased corporate spreads. Knowing this the interest rate risk deserves also to be monitored in the beginning of the year. We continue to manage the interest rate risk actively in our Fixed Income portfolio. We maintain the corporate bonds in overweight in our allocation. We anticipate that the yield of corporate bonds will be good this year.

Equities

Past events

A peculiar year reached its end calmly

Very controversial and turbulent year ended up in calm atmosphere. In December, the European food and beverages sector (+6.6%) as well as health care (+7.9%) continued their relative overperformance against main indices (Stoxx 600 +2.7%) as willingness to take risk stayed at a low level. In the food chain the valuation of some companies is starting to become challenging following the recent run (e.g. Unilever 17x 2012 earnings). Trading volumes shrank as expected towards the end of the year, and no political news arrived to shake the already timid market sentiment.

In the US, main indices wrestled themselves to positive territory in 2011 (in local currency), but looking at the investment flow we can see the outflow from American funds has continued during Q4 (-63 billion USD). During the year, the net outflow from the funds was approximately –120 billion USD in 2011, which means fund investors are still quite cautious. In December, we yet again swam against the market flow and raised equity weights on December 20 (from 40% to 60% in high risk products). In Finland, the main stock index ended the year –28.8% below starting levels of year 2011. At the same time, ML Finland Dividend lost –13.3% of its worth.

Current situation

S&P 500 currently priced 12 times 2012 earnings

Stock market valuation multiples have changed very little at the latter part of the year. At the moment, company analysts are clearly more optimistic than generalists (top down economists). The consensus forecast still expects US corporate earnings to increase by +10% this year, followed by a +12% increase in 2013. Earnings margins are expected to grow as much as +15% this year, which would be an amazing result for American companies. We suspect the earnings margins forecasts need to be revised to a lower level during the first part of the year. In Finland stock markets are starting to look attractive in light of earnings forecasts but in the US earnings revisions have been small. In fact, revision ratio (meaning the ratio between earnings forecast increases and decreases) even increased a little in December in the US. At the moment, looking at the forward P/E S&P 500 index is priced 12 times the forecasted earnings. This is why we believe there is more downside pressure than upside lift. In Europe, the year turned with the consensus forecast being +10% for 2012 and yet another +10% in 2013, when it comes to corporate earnings. The expectations still give room to move downwards if a deeper recession starts to look more probable during the next few months. We will most likely start the year with a series of profit warnings as companies prepare to report their 2011 results. The outlook for 2012 will remain fuzzy, as a result of the debt crisis in the Southernmost European countries will limit the demand side considerably due to lack of trust and the situation of European banks. This “credit impulse” is caused by the tightness of funding for banks. The cracks in the banking sector affects economic activity directly through rising interest rates.

The future

Macro newsflow in the driver’s seat in January

In Europe, politicians start about the debt crisis in January and we might see a new summit at the end of the month. European banks are beginning to strengthen their solvency according to authority and market requirements. The Italian Unicredito was forced to offer its shares with a –43% discount as it emitted new shares in the beginning of the year. This send a rough message to the banks and decisionmakers about how enthusiastic investors are about the banking sector in the crisis countries. The finance sector has continued to underperform main indices around the turn of the year and the situation will remain fragile in January. We expect volatility to rise from current levels during the first half of the year as the markets are seriously starting to take into account the possibilities of Italy and Spain to overcome their government bond emission calendars. At the same time, private sector investors are facing new pressures to accept private sector involvement (PSI) in the Greece debt cuts. Unless Greece receives to next lot of the rescue package, the country is likely to start drifting away from the Euro zone. This is why we believe the development of the PSI situation when it comes the Greek debt is one of the cornerstones which either awake the reprising of tail risks in the markets or the situation starts slowly boiling. There is also a considerable macro and geopolitical risk lying in the Strait of Hormuz at the moment, as Iran has threatened to close the strait which is the most prominent distribution channel for Saudi Arabian oil. Should the price of oil shoot up, it would seriously damage the recovery of the US economy. Despite all this we aim at neutral equity weights in January.

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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 recommendation remains neutral. The previous year was really challenging for hedge funds, when HRFX general index for long-short strategy funds on equity markets went down by -19%. The general index for all strategies fell by –8,7% last year. This describes the year well when comes to risk taking. Our hedge funds on the fixed income side reached a positive result.

Commodities

The oil price rice during the year change is to continue, if the state of affairs in the Strait of Hormuz becomes more critical. Some upward pressure is also otherwise seen in the commodity prices which follow thus the oil price. We are scanning carefully potential possibilities, specially among agricultural commodities. Corn went up by +10% at the end of the year after having reached bottom values in December. According to our analysis, the hedge funds have on average moderately added equity weights after the mid-December. The allocation recommendation is kept neutral inside the alternative investments.

Market outlook (change to previous month)		Monthly recommendations 8/2009 - 1/2012*																													
		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
Fixed Income: Neutral	**(=)**	4	3	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	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	2	2	2	2	2
Europe government bonds: Underweight	(=)	3	2	2	2	2	1	1	2	2	2	1	1	1	1	1	1	1	1	2	2	1	1	1	1	1	1	1	1	1	1
Investment grade: Overweight	(=)	5	5	4	4	4	4	4	4	4	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	4	5	5	5	5
High yield and structured products: Moderate overweight	(=)	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	4
Emerging market bonds: Moderate underweight	(=)	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	2
Inflation: Neutral	(=)	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	3
Equities: Neutral	**(=)**	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	2	2	2	3	3
USA: Moderate underweight	(=)	4	4	3	3	4	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	(=)	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	4	4
Japan: Moderate underweight	(=)	2	2	2	1	1	1	1	1	2	2	2	2	2	2	2	1	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Emerging markets: Neutral	(=)	4	4	4	3	4	4	5	4	5	5	5	5	5	5	5	5	5	4	3	3	3	4	4	4	4	4	3	3	3	3
Alternative Investments: Neutral	**(=)**	2	2	2	2	3	3	3	3	3	3	3	3	3	3	3	3	3	4	4	4	4	4	4	3	3	3	3	3	3	3
Private equity: Underweight	(=)	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	1	1	1	1	1
Real estate: Neutral	(=)	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	3	4	3	4	4	4	4	5	5	4	4	4	4	4	4	4	4	4	4	3	3	3	3	3	3	3	3	3	3
Convertible bonds: Neutral	(=)	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	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	3	3

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