Nordic Investment Partners

Roadmap

2018

Roadmap 2018

A constructive and good return year lies ahead

Roadmaps can be quite static as the route you see on a map is much different when it becomes reality. How often have you not imagined a new holiday destination only to realize it's completely different to what you imagined? A financial market roadmap gives directions, but one has to be open-minded to change route if road conditions or weather forecasts change substantially

My roadmap for 2018 can be boiled down to;

1. Global GDP growth will be best for many years at 3.5% pace. Europe and US will grow 2-3%, while China and India will be the absolute locomotives with 6% growth
2. Inflation will remain subdued and interest rates will remain low. However, Central Banks will start to withdraw excess liquidity by summer 2018. The removal of easy money will be done carefully not to cause unnecessary volatility, but no guarantees are given
3. Corporate health is good and the overall economic expansion will translate into 8-10% better earnings and 2.5% dividends. Consequently, stocks should return 10-12% in 2018
4. Given the valuation the return profile for Europe is more attractive than US. The US return profile could be impacted negatively by higher interest rates that hurt the highly valued companies
5. When interest rate increases it's good for earnings in banks and that has not been fully factored into stock prices. Consequently, I see interest sensitive stocks like banks doing better
6. Risks are geo-political jitters (North Korea, Saudi and Venezuela), economic problems in China, first signs of inflation from wage bottlenecks as well as clumsy handling of central banks removal of easy money
7. 2018 is Year of the Dog. It's faithful, serious and constructive, so the Chinese zodiac will likely bring a good investment year just as previous Dog years; 1982, 1994 and 2006

Happy new year and a prosperous 2018

Ole Søeberg
ole.soeberg@nordic-investment-partners.com
+45 4030 0004

Economic activity

Since the severe global recession in 2008/09 the political agenda has focused to creating better stability in the financial systems, while stimulating economic activity.

Global economic activity is good

Various infrastructure programs and activities was complemented very by aggressive monetary policy. The economic pace from 2010-17 has been moderate in Europe and Japan, somewhat better in US and with good pace in China and India. Performance in other regions has been very mixed illustrated with lengthy recession in Brazil and Russia.

The roadmap for 2018 points to continued good pace and a synchronized upswing. Basically, it's the same tune as the past 1-2 years;

Key economic indicators	Size	2016	2017	2018	2019
US GDP	18trl $	1,5	2,2	2,5	2,1
Euro GDP	18trl$	1,8	2,4	2,1	1,9
China GDP	11trl $	6,7	6,8	6,6	6,4
Global GDP	78trl$	3,6	3,7	3,6	3,4
Inflation rates					
US inflation		1,3	2,0	2,0	2,1
Euro inflation		0,2	1,5	1,5	1,7
China Inflation		2,1	1,5	1,8	2,0

Source: IMF and OECD and annual change in percent

Inflation to remain below 2%

Inflation expectations are around 1.5-2.0% which is a fine level. You need to monitor wage inflation and energy prices in the coming period. Unemployment is at multi-year lows and participation rates are high, which normally means higher wages to attract workforce. Also, most of the world economy has benefitted from lower oil prices since 2015 but as oil prices are creeping upward it could result in higher inflation down the road.

Commodities

Oil could go higher

Commodities are like canaries in the coal-mine. You can't smell carbon dioxide and canaries faint faster than humans, so when the canary bird fall down in its cage it's about time to get out. Oil is by far the largest commodity in the world with an annual traded value of 2.2trl $. For comparison, the global car industry has 1.8 trl $ in revenues and the global pharmaceutical industry is at 1.3 trl $

Commodities tell quite early how the economic pace is going. However, there's a lot of short term noise from speculators and event driven impacts on supply and demand. Longer term trends are driven by finding new resources and demand patterns.

Commodities shows a mixed picture, however oil looks to continue upward

Commodities	Unit	Price now	2018	2019	2020
Brent oil	1 barrel	63.88	60	68	72
Global oil demand	Barrels/day	97.70m	98.9m	101.0m	102.0m
Global oil supply	Barrels/day	97.30m	99.1m	100.5m	101.5m
Aluminium	$/ton	2.035	2.050	1.900	1.800
Copper CME	$/ton	3.095	3.200	3.200	3.400
Gold	$/oz	1.260	1.350	1.400	1.450

Consensus is for flat to lower oil prices

The roadmap for 2018 differs from the consensus forecast as consensus sees oil prices of 55-60 $ toward 2020.

The reason for taking another route is the fact that global exploration for new oil resources have been low since 2014. In fact, it's the lowest since the mid 1990'ies when oil was below 20 $.

Looking 20 years down the road non-fossil energy will dominate the new power production as renewables take the scene with force. But the next few years is still traditional supply and demand and as global growth is good the consumers in Asia, Africa and Latam will use more oil for power and transport. The supply side has not looked for new oil as they used to do, so a tight market could likely be a reality sooner than investors think.

Interest rates

Interest rate will go up in 2018

The inflation outlook is for 1.5-2.0% in the major economies and I see higher interest rates as global growth can do without artificial low interest rates. The financial systems are not sick anymore and even the Greek banks are in reasonable shape albeit they can't run a marathon. But the financial systems have the lubrication back to normal after 9 years recovery, so interest rates should start to normalize.

The US has already embarked on a journey towards normalization of interest rates, while Europe still gives away money.

During 2018 the US central bank will start selling bonds they bought to relief the financial system. This is planned to occur in 2Q 2018 so you need to monitor how that is being absorbed by the commercial market. Also, FED has already said they intend to increase short rates three times in 2018. Hence the 2.25% target by end 2018.

In Europe, the monthly relief program of buying 60bn € worth of bonds from financial institutions will be scaled down to 30bn € per month from January 2018 and by September 2018 it ends. When selling of the bonds starts has not been communicated yet.

Normalization has started and withdrawal of easy money will continue

Interest rates should start to normalize in 2018 and onwards

Interest rates in %	2016	2017	2018	2019
US FED Funds	0,50	1,50	2,25	2,75
US 2-year rates	1,20	1,84	2,50	2,75
US 10-year rates	2,44	2,37	2,75	3,00
Euro 3-month rates	-0,93	-1,10	0,00	1,00
Euro 10-year rates	0,21	0,31	1,50	2,25

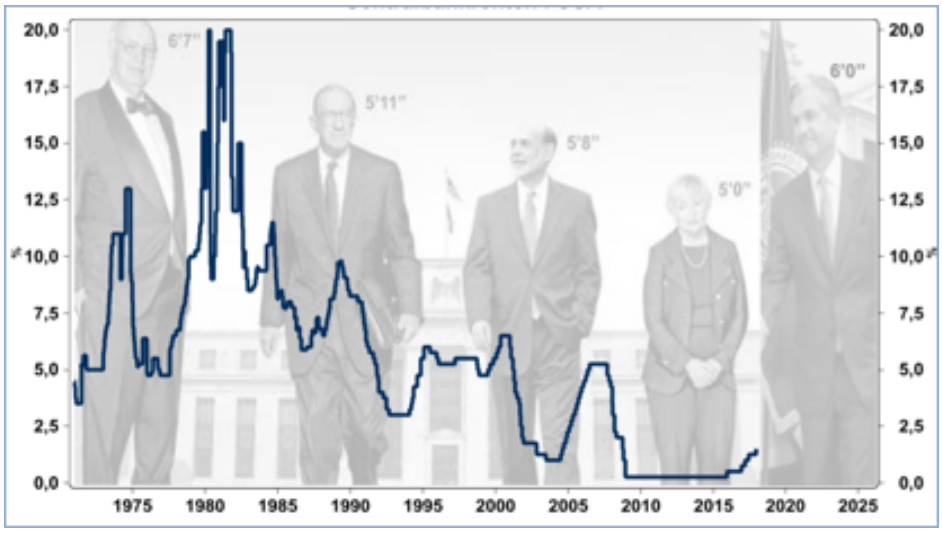
Good news for savers

More than 8 trl $ of bonds have negative return, so normalization will be liked by savers and disliked by borrowers

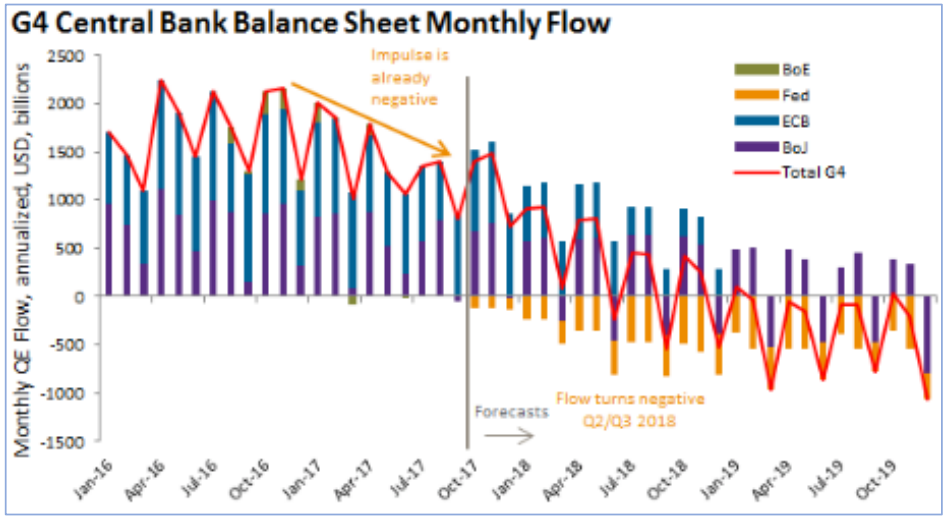
The roadmap for interest rates in 2018 is along the lines of consensus. The reaction to withdrawal of very easy monetary conditions will be interesting to monitor. Some early birds are already seeing the next soft pace in economic pace, which argues for a delay of withdrawal, but let's see what happens.

Let's see if the correlation works

US FED funds rates correlation to height of Federal Reserve chief



Central banks will reverse their relief programs



Stock markets

2017 was much better than expected in Asia and US

2017 global stock markets turned out to be much better than expected. Measured in $ MSCI World was up 23% driven by a 32% move in Asia and 20% move in US. European stocks rose 19% in $, but a more modest 8% in €. The Nordic region was the worst performer together with Russia.

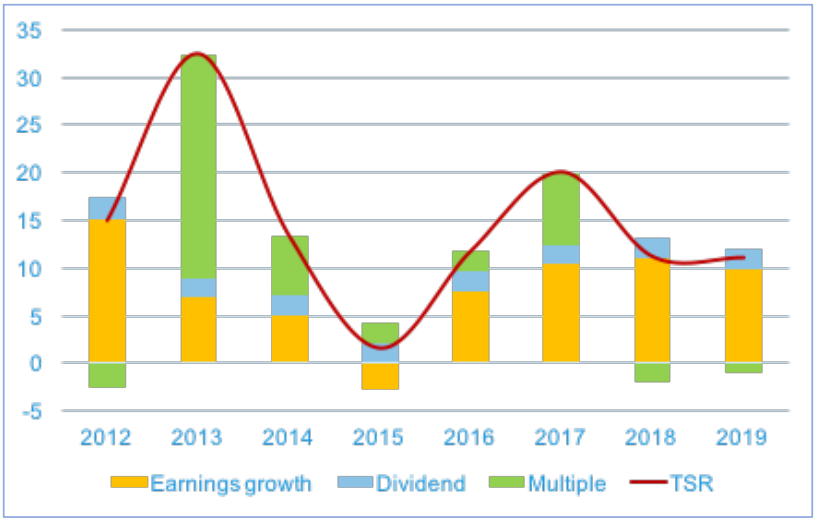
Europe did as expected

The 2017 roadmap was for 7% return in US, 8% in Europe and 14% in Emerging markets. Clearly EM and US did much better. In the US the performance was driven by higher earnings and higher valuations. The higher valuation in 2017 can partly be explained by lower corporate tax-rates from 2018 and onwards.

The impressive performance in Emerging markets was driven by tech companies in Asia that saw massive increases in earnings of 30% and on top came higher valuations for a total tech return of 42% in $.

In the figures below you see how the various components generated returns in the past

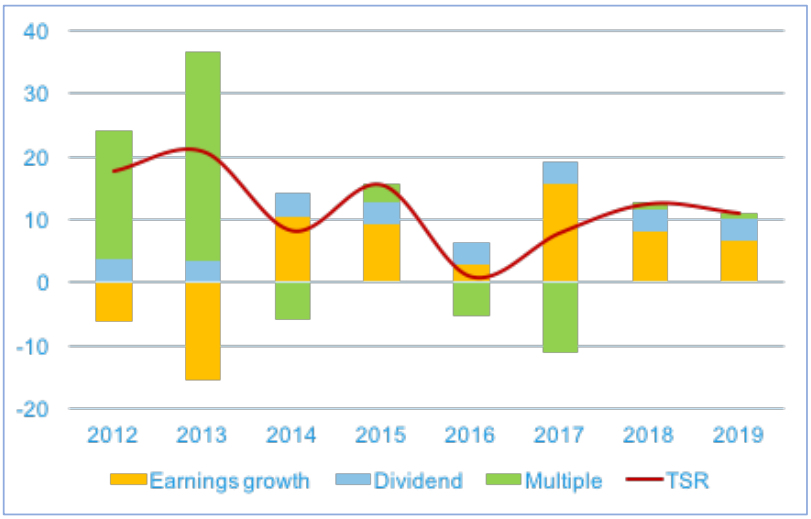
S&P500 in $ total return (TSR) broken down in components



The 2017 multiple expansion in US was also fueled by more corporate takeovers in the tech and media sectors. In 2018-19 I see a small multiple contraction due to higher interest rates.

In Europe performance turned out to be more or less as forecast in 2017, however earnings growth was actually quite good and driven by a rebound in the energy sector. Hence, 2017 saw a contraction of valuation as earnings rebounded from the 2016 pause.

Stoxx600 in € total return (TSR) broken down in components



Roadmap 2018 points toward 10-12% total return

The roadmap for 2018 boils down to another good year in the markets. The amount of moving parts that determine individual stock prices and subsequently stock indices are enormous. The roadmap will consequently never show how the route really looks like, but at least you have a sense of direction and your ability to maneuver improves.

Earnings growth is the key driver for long term value creation

A bit lower return in US after a solid run in 2017

Stock market	Price	EPS growth			P/E target	Price return
		2017	2018	2019		
MSCI World $	507	33%	11%	10%	16,5	12%
S&P 500 $	2.676	10%	11%	10%	18,0	8%
Stoxx600 €	391	16%	10%	6%	15,5	13%

The underlying earnings data need to be monitored as 2018 progress and by end 2017 this is how it looks;

Index	EPS16	EPS17	EPS18	EPS19	EPS20
MSCI World $	21,33	28,45	31,48	34,50	37,00
S&P 500 $	119,0	131,4	146,0	160,3	168,0
Stoxx600 €	21,00	24,30	26,80	28,50	31,20

Based on all the data I believe Europe should do better than US in 2018 as the mix between earnings growth, economic cycle and valuation favors Europe.
It's fair to ask why Europe has lagged US for the last 7 years and why that should change. US took firm action just after 2008/09 downturn, while European bureaucrats had to go through lengthy procedures before they could move. And in 2016 Britain decided to leave the party – a clear signal about how some populations view big government.

I see higher valuations in Europe as the economies continue to improve and interest rates stay low. Europe will not reach US valuation levels as Europe has more traditional industries than the US. As example; European stock market is 21% banks, while its only 15% in US. US holds some of the fastest growing global tech and media companies, while Europe have few of those companies.

It is almost impossible to say when the valuation of US global tech and media leaders have become too stretchy, but I nevertheless factor small declines in valuation as US interest rates go up. Stocks trading above 40x earnings are at higher risk in periods of multiple contractions, so I'm cautious on valuation for that group.

Sentiment readings

Equities are most popular, but cash is number 2….

Its always of value to know what the other players on a table thinks about the game. For that information I participated in a survey about most and least liked financial assets for 2018. What surprised me is that 20% of participants prefer to hold cash – you only hold cash at low/negative interest rates if you think all other assets will decline in value. So, 1 out of 5 think 2018 will be a poor year. If things work out as I see it some of the sidelined cash will rush back into assets with decent return/risk profile at set-backs.

Most popular assets for 2018

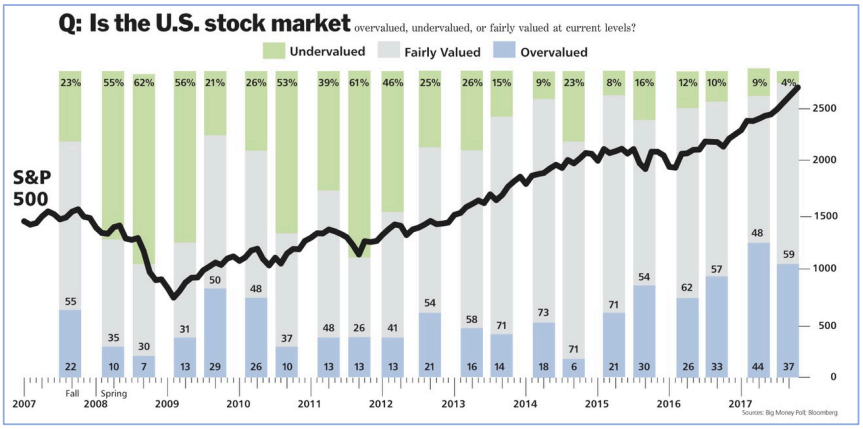
Most popular assets for 2018 are;

Asset	Percent of investors vote as best asset 2018
Equities	58%
Cash	20%
Commodities	18%
Bonds	3%
Corporate credit	1%

Pricing of high growth and high valuation companies have dominated stock index performance in the past years

A graph I like from Barron's is their surveys of how investors view the stock market. Since the latest survey where few saw it as undervalued it's run up another 5%. Valuation sentiment is a very bad short-term driver of prices in the stock market, but eventually the gravity forces in financial markets work. This relates to pricing of high growth and high valuation companies that have dominated stock index performance in the past years

Value oriented investors tread carefully while index funds just buys and buys



European sectors that stand out

Given the roadmap focus that Europe will do better than US I took a helicopter view of European sectors. Media and energy sectors are seeing earnings rebound in 2017, which help the PEG equation. Automotive is always attractive on this measure due to traditional low valuation due to the industry's sensitivity to economic cycles.

Europe and sectors with lower than market PEG ratios

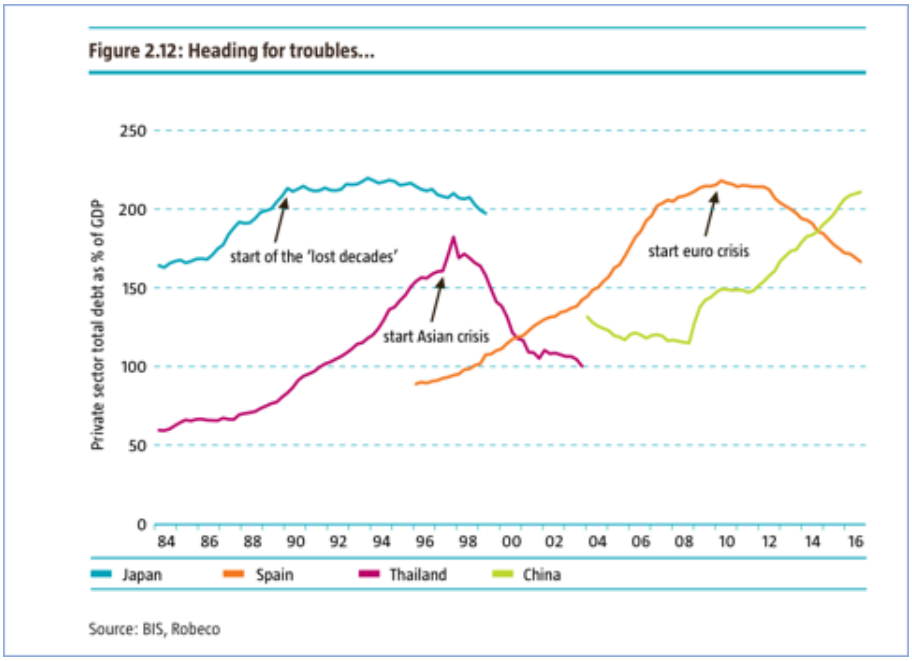
Sectors	Price	EPS growth		P/E 2018	PEG ratio
		2018	2019		
Europe		**10,0**	**6,0**	**15,0**	**188**
Media		17,5	11,1	14,2	99
Banks		6,7	8,6	11,5	150
Tech		12,4	13,8	20,7	158
Telecom		9,5	9,0	14,9	161
Energy		9,1	9,9	15,5	163
Automotive		6,5	5,8	8,2	133
Industrials		10,4	11	17,4	163

PEG ratio is P/E divided by EPS growth rate average two years

A financial market roadmap gives directions, but one has to be open-minded to change route if road conditions or weather forecasts change substantially. As such the above only serves as a suggestion for things to look for.

Risks or unexpected moves to watch out for

The main roadmap is clear (I hope) so just to be prepared here's a list of things to keep an eye on. Remember that severe economic downturns come when there's too much debt in a society. The savers lend to the borrowers and when the borrowers are unable to pay back their debts the saver take their assets are sell them quickly at whatever price they can get. The main worry of this kind in 2018 comes from the Chinses theater;



Other risks to be considered;

Event	How it unfold	Action plan
Upside risk and S&P500 moves to 3.200 (+20%)	Tech stocks continue their heavenly flight and being followed by banks	Watch it and do not run after the tech stuff as demand/supply statistics do not support it for 2018. Enjoy the bank ride

Down side and S&P500 moves to 2.000 (-25%)	US economy slows down as consumers use wages to pay down debts	High P/E stocks dependent on EPS growth will decline 40%. Move to cash once there's a few data points pointing in that direction
Bitcoin goes to 250.000$	With 40m block chain codes crypto currencies could be seen as a short supply asset	Watch it from the sidelines just as you watched the Beanie Baby bubble in 1990'ies
Bitcoin goes to 100$	Central bank and government regulation introduced to block chain system	No surprise, but a couple of 100.000 people probably learned a lesson
US GDP growth exceed 4%	Trump has bragged that US will grow faster than 4%, so America obey	Would make $ and US interests rates go up and would look like 1987, so watch out as FED withdraw liquidity fast
Geo-political turmoil	Escalation of war threats and chaos in Korean peninsula, Arabian region or Northern Latin America	Not much you can do as events happen quickly and the main reason for always having a bit of cash on the sidelines
European economic improvement stalls	Weaker $ reduce corporate competitiveness and dometic demand is still weak due to relatively high unemployment	ECB will not withdraw easy money and negative interest rates will remain. Good for real estate and not good for banks

This document is for private purposes only and shared only to friends

December 2017