Nordic Investment Partners

December 2018

Roadmap

2019

Roadmap 2019

15 December 2018

Road looks decent despite current volatile forecasts

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

Consensus is constructive…

…while media is focused on recession signals and moves in financial assets

Use the radio to keep updated on road conditions and be sure your vehicle is able to handle the journey

General roadmap for 2019 summarizes as follows;

1. Global economic activity will continue at good pace unless a uncon-structive global trade war evolve i.e. **the road condition is good**
2. Inflation and interests are moving slightly higher and the accommodative central bank behavior since 2009 is being rolled back gradually i.e. **the cost of driving is a bit up, but nothing serious**
3. Corporate health is relatively good, despite some companies have borrowed a bit too much while interests where low so investors need to travel more carefully with companies with a lot of debt in the trunk i.e. **the vehicles are also in good shape but watch out for debts**
4. Valuation contracted in 2018 and current levels are neutral in historical perspective i.e. **the value of the vehicles varies but average is not expensive** after valuations declined 15-20% in 2018
5. Risk are the long published recession in USA in 2020, China slowdown and dysfunctional Europe falling apart i.e. **the traffic obstructions and planned roadworks are the same as last year**
6. New hurdles and fast stretches of road will occur so check the updates during 2019

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My views are to be found in the sections of this roadmap, but for summary I see these road conditions, which are not direct part of the general consensus;

To get into a sustainable long term growth scenario we need to see higher productivity

I believe it will come, but not necessarily in 2019

- The world is getting more and more affluent every day. Living standards, health and education is on the rise for billions of people. The so-called global middleclass (defined as 12-15.000$ income per year) rise by 300.000 individuals every day or 110m people per year
- Productivity in developed economies have seen a decline since 2008. I see higher productivity going forward as digitalization in R&D, health-care, supply chain automation, robotics, finance, corporate management systems, self-driving vehicles as well as advances in sustainable energy and new materials drives higher productivity. It must however both be in the private sector and public sector to have an effect, so I'm less certain of how much will land in 2019. Probably not much more than usual i.e. 1-2% improvement on 2018

Bull markets do not die of old age

- After 7-9 years of bull market a general fatigue is starting to show up as investors argue that long bull markets have to end sooner or later. The underlying earnings growth has been supportive and markets started from a low base in 2009-11, so unless we get lower profitability things will continue upward.

Is Europe like a car that will not start?

Its noteworthy that Europe has been flat for 4 years, so it's fair to ask if Europe is a car that will not start? It's my view that Europe has more to it than the current cautious investor perception created by the noise from Brexit and Italy.

Enjoy the read and happy 2019

Middle of the road forecast for 2019

Consensus is fairly constructive for 2019 performance

Only a small percentage of economists see recession in 2019 or 2020, but several predict a slowdown

Roadmap 2019 in numbers (middle of the road);

Asset	Price now	End 2019	Comment
S&P500	2.650	2.900	8% earnings growth and P/E 16.5x for an upside of 9%
Stoxx600	349	382	8% earnings growth and P/E 13.5x for an upside of 9%
MSCI Asia Pac	151	156	6% earnings growth and P/E 12.5x for an upside of 3%
$/DKK	6.56	6.25	Relative growth goes to Europe as US GDP growth rate declines and Europe stabilize
US 10 year	2.91%	2.75%	Slower growth rate in 2020 and FED to be more accommodative
EU 10 year	0.28%	0.75%	ECB stops bond buy backs, but keep short term rates low
Oil	60$	70$	Supply continues to tighten as offshore exploration has declined and its 30% of total supply
Global GDP growth	3.5%	3.3%	1.8% pace in Europe and US, while India hold the yellow jersey with 7.5% growth and China with 6.2% growth

Risks and upside surprises

The consensus risk factors going into 2019 are;

Trade war escalation

Recession in 2020

Brexit and EU falling apart

China slowdown due to debts

Large stock market declines happens from three factors;

1) Recession in economy or earnings

2) Valuations gets out of sync with reality and then normalize

3) Shock to the system like war, terror, epidemics or lack of trust in financial system

A stock market decline is not the same as a factor reality and the 2018 decline is difficult to put into one of the three categories, but it's mostly a factor 3 i.e. increased risk premium related to uncertainty around a volatile political roadmap due to trade war, Brexit etc.

Most conflicts in the last 500 years are made by politicians, religious and ideologists groups.
During 2010s I observe an increase in dissatisfaction in the broad population about how lawmakers and politicians have managed countries including demographic challenges with more immigrants in the wealthy parts of the world, inequality and so on.
The stalemate in Swedish politics tells a lot about a nation that has been very social and democratic for ages.

I have no special insight into recessions etc before anyone else. Same goes for military conflicts or credit crunch. However, I observe there has only been two major global crisis in my lifetime; the energy crisis in 1970s and the close to financial meltdown in 2008-90. The tech-bubble burst, the crash in '87 and Greek crisis are smaller events in a global perspective, so major crisis are very unusual despite media would like it more often.

On the next page you find my highlighted risks and volatility factors for 2019

Event and likeliness	How it unfold	Action plan
Global stocks decline more than 20% **(15% probability)**	China and US economies come to standstill as trade war escalates	Go cash or at least into very predictable exposures live consumer stables
Wage inflation exceed 4% and profitability decline **(10% probability)**	Mostly an US problem, but there's wage pressure in US which eventually will eat into earnings	Monitor monthly wage data and employment trends
Financial market collapse due to algorithms and robot trading running out of control **(5% probability)**	Daily trading volume is dominated by automated trading algorithms. On top comes various AI asset allocation operators primarily using momentum and trend signals	This can happen without warning like the 'flash crash' in 2010. Stock exchange authorities must pull the power plug from all connected computers and stop trading activities
US$ declines more than 10% **(15% probability)**	US economy slows and the budget deficit start to accelerate	Monitor US economic health and be prepared to move out of US$ exposures
Global debt is 184 trl $ and systemic risk high. A trust decline trigger 40% stock market decline **(5% probability)**	Rising debts started in 1980 but its getting most acute in Japan, China and US. A rise in bond yields could be a warning	This scenario will unfold within the nest 25 years unless governments stop spending coming generations money
Cyberattacks or solar storms that close down power grids and communication **(1% probability)**	This will happen without warning. Our digital infrastructures would grind to sudden halt	You can store your data other places than cloud, but no power gives you times off Batteries only last short, but petrol and gas will work
Epidemic going to local to region and global proportions **(below 1% probability)**	It happened in 1918 and 1957 and financial assets declined 30-40% It starts slowly and then expand at high speed	You can't prepare for this, but follow news and events Some pharma companies might cure the problem

Upside surprises

Upside surprises work more slowly as stocks walk up the stairs and take the elevator down	The risk matrix can also serve the other way, but as we all have learnt; stock walk up the stairs and take the elevator down; declines occur with three times the speed of increases. Big upside moves happen slowly and only a few times its faster such as rebounds after long declines, the tech bubble 1999-2000 and the relief rallies in January 1991 and March 2009. The upside surprises I can imagine for 2019 are;

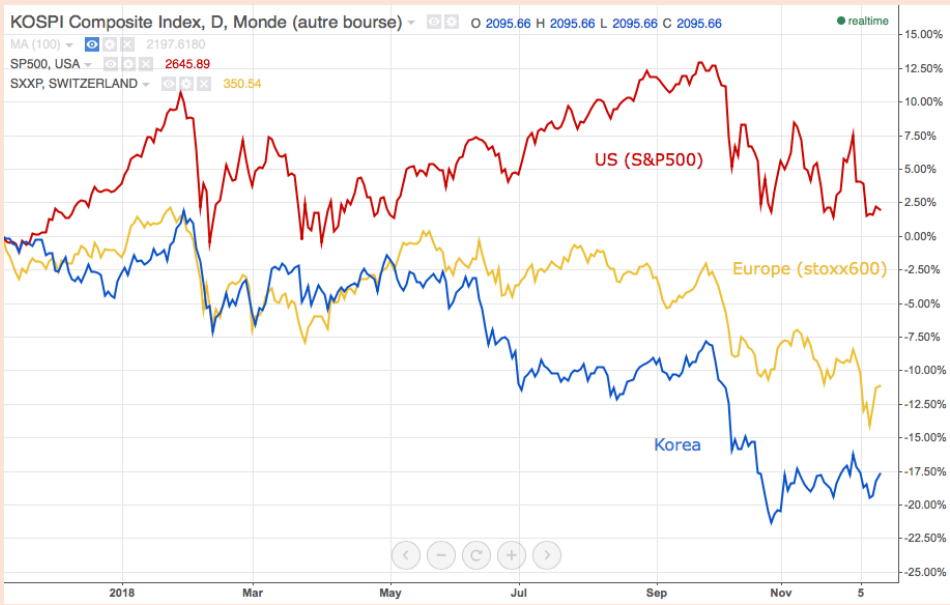
Event and likeliness	How it unfold	Action plan
Constructive outcome of trade war between China and US (25% probability)	China and US agree on a new trade system. First a Trump tweet and then Xi confirms a few days later	Automotive, shipping and other sectors that are down 30-50% in 2018 will make a very strong rebound
Global stocks rise 20% (18% probability)	A relief rally to political volatility and improvement in key economic indicators. Occurs over several months	When news flow start to improve investors will be skeptical after many false signals in 2H 2018, so the market move itself will be best indicator. Load up to your maximum risk tolerance
Brexit makes a smooth transition (2% probability)	Britain and EU agree on a constructive pact for both sides	It's a slow process so will be in media before it is a reality. GBP strengthen and shares rally in relief. Difficult to position before it occurs.
FED stop rate increases and introduce a Truman era policy where higher inflation reduce the debt burden (below 4% probability)	FEDs Powell tells at a FED press meeting and shows how they did in 1947-53. Trump tweets. Paul Ryan join the Communist party	Reduction of the debt load in real terms would be a huge relief for indebted companies, organizations and US government

The run-up to 2019

2018 went fine on fundamentals, but for financial assets it was a poor year

2018 overall factors like economic growth and earnings did well and in many cases even better and expected at the beginning of 2018..
For financial assets 2018 was however a year in two very different halves; first half was good with momentum and more of the same as the previous years, while second half was a challenge as trade war and negative momentum strategies took the stage.

S&P500, Stoxx 600 and Kospi (Korea) performance in 2018



Momentum strategies have been the big winners

Over the last 7-8 years the best factor has been momentum. The momentum strategy is very simple as you just buy stocks that are rising irrespective of how other things like earnings and valuation develop. However, in 2H 2018 the momentum strategy has folded and Quality has taken over. Also, Value style has started to perform better than Growth style, but that's probably a function of the Momentum collapse more than a new dawn for Value style.

Korea (South) down 20% since June 2018 is a good proxy for Asia and how the global production hub is impacted by trade war worries. Also, Europe is down 12% in 2018 and flat for 4 years despite zero interest rates, 30% higher earnings and a valuation that's below long term average.

Industrial and commodity forecasts

Industrial products tell a lot about how the global economy moves

Several commodities and industrial products tell about global activity levels. I like the ones below, which are a mix of current key trends and more traditional commodities;

Newer economy indicators. Foldable smartphones only take off in 2020

Item	Measure	2016	2017	2018	2019	2020
Smartphones	Units	1.470m	1.466m	1.435	1.460	1.600
Cars, SUV and vans	Units	92m	94m	97m	99m	102m
Semiconductor sales	USD	339bn	412bn	463bn	484bn	515bn
Data center traffic	Zettabytes	6,8	9,1	11,6	14,1	17,1

Source; ACEA, DRAM Exchange, Intelligencer and Cisco

I guess the first three explain themselves, but its mind boggling that one zettabyte is the same storage as 7.8 billion iPhones with 128 GB memory. Netflix and other streaming services are rapidly making data center cooling into the biggest electricity user globally.

Traditional commodities also tell their story and copper and oil could come in short supply by 2020/21

Commodities	Unit	Current	Forecast 2018	2019	2020	2021
Brent oil	1 barrel	61,5	60	70	75	80
Global oil demand	Barrels/day	99.2m	98.9m	100.4m	102.0m	103.3m
Global oil supply	Barrels/day	100.7m	99.1m	101.0m	101.5m	102.5m
Aluminium	$/ton	1.955	2.050	1.850	1.800	1.750
Copper CME	$/ton	2.748	3.200	3.200	3.400	4.000
Gold	$/oz	1.254	1.350	1.200	1.100	1.150

Source: Bloomberg, IEA, futures markets and company reports

Just a note on the Brent oil price; inside 2018 the price rose and fell from 60 $ to 85$ and back to 60 $. The medium term demand/supply picture favors a higher oil price as roughly 30% of global supply is offshore and since 2014 oil price collapse the offshore oil reserves are down by 35%. That is unsustainable in the medium term as on-shore oil production cannot meet that supply gap.
Also, despite all the hullabaloo around US share oil its cash flow negative below 75$, so to get to market balance we need to have 75$ oil or more

Economic pace 2019 – steering in a soft patch

Recession and bad stock markets makes headlines

Global economic pace has been good for the past few years and due to continued stimulative monetary condition and/or government spending to boost activity.

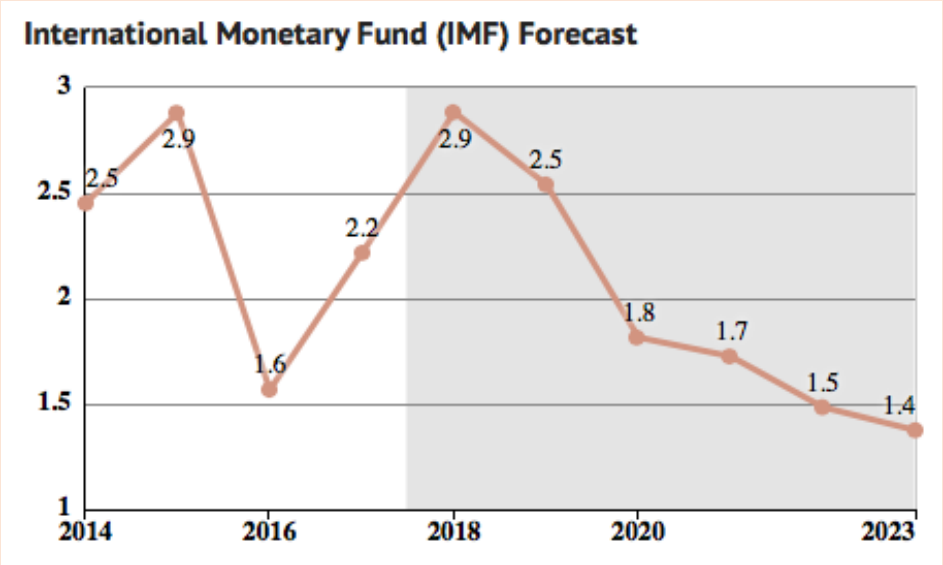
Key economic indicato	Size	2017	2018	2019	2020
US GDP	18trl $	2,3	2,9	1,8	1,7
Euro area GDP	18trl$	2,4	2,1	1,7	1,5
China GDP	11trl $	6,9	6,5	6,2	6,1
Global GDP	78trl$	3,7	3,5	3,3	3,1
Inflation rates					
US inflation		2,1	2,5	2,3	2,2
Euro inflation		1,5	1,6	1,8	1,9
China Inflation		1,5	1,9	2,0	2,1

Source: IMF and OECD and annual change in percent

Even the most respected business media get it wrong more than half the time

US economic speed surprised in 2018 and was driven by lower taxes that stimulated activity. The budget deficit rose significantly and the longer term implication from that exercise is a challenge for coming years. IMF sees slower growth in US, but no recession in the coming years;

Pace of economic growth in USA



Europe will roll back ECB bond purchases in 2019, so rate will likely rise as they did in USA

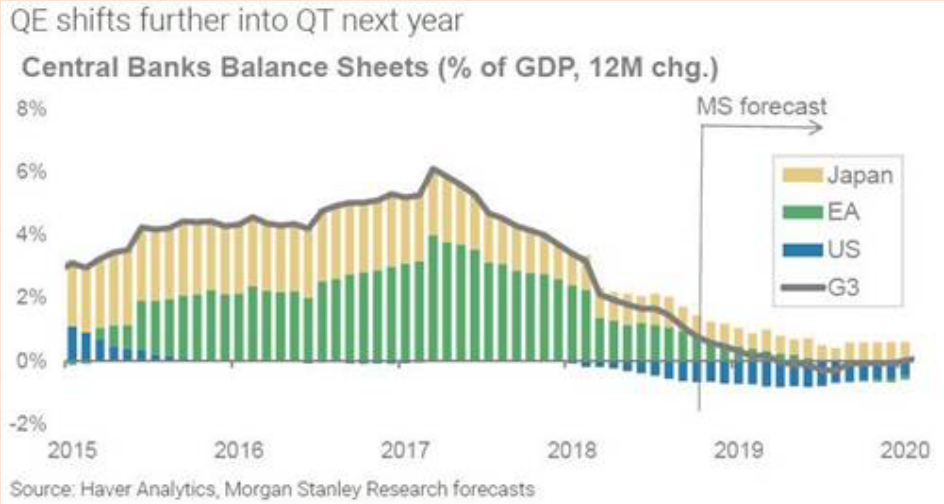
Europe is a car that will not start, but ECB will nevertheless stop their bond purchase program by end of 2018. It is widely believed ECB will continue to keep short term rates very low so in 2019 its likely we will continue to see negative short term rates, while the 10-year rates move closer to a normal level

Interest rates in %	Current	Forecast 2018	2019	2020	2021
US FED Funds	2,25	2,25	2,50	2,00	1,50
US 2-year rates	2,76	2,50	2,85	2,00	1,75
US 10-year rates	2,91	2,75	2,85	3,00	2,75
Euro 3-month rates	-0,58	0,00	0,00	1,00	1,50
Euro 10-year rates	0,28	1,50	0,75	2,00	2,50

FED in US is expected to do one or two more interest rate hikes, but with the economic roadmap they have become a bit more cautious on raising too much. Remember, FED is now run by a lawyer, so he don't want to sued

We are getting back to normal in most major regions, which is good for a wellfunctioning financial market

Easy money drove economic activity and financial assets until 2018. The road forward is less accommodative as shown in this chart from MS;



Stock markets in 2019

2018 was an unusual year as corporate performance was good, but stock prices nevertheless fell. The last time I recall such a market was in 1990, 1998 and 2011.

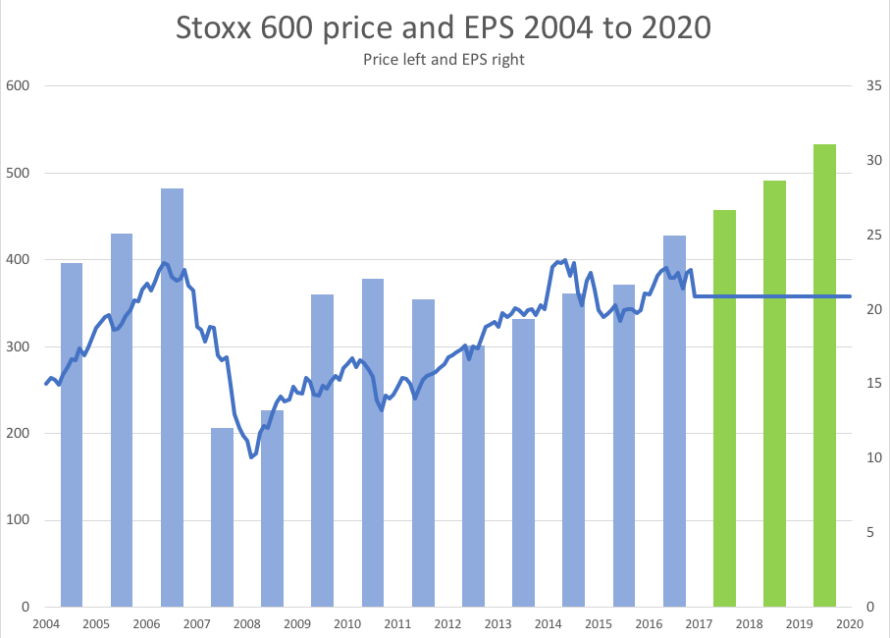
Going into 2019 there's a few facts to keep in mind;

1. Corporate health is good
2. Profitability is record high even with lack luster sales growth in many industries
3. Valuation is neutral and even inexpensive in some sub-regions;

Stock market		P/E level and history		
	Price	Current	10 year average	20 year average
MSCI World $	485	14,4	14,4	15,1
S&P 500 $	2.633	15,6	15,0	15,8
Stoxx600 €	358	12,7	13,0	14,0

Europe has increased earnings 30% over past 4 years and valuation is below long term average, but its still dead in the water

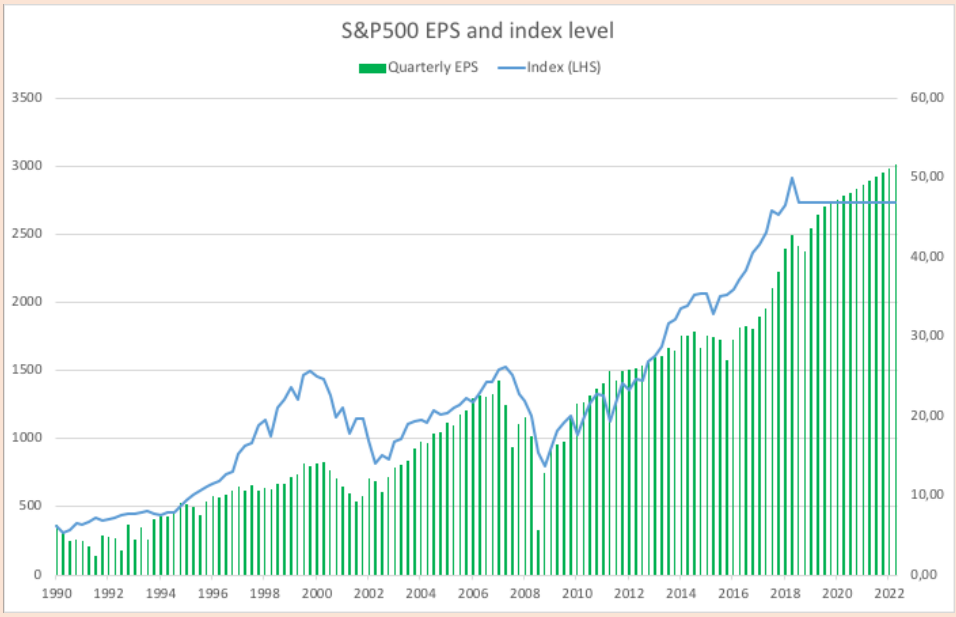
Corporate health measured by EPS for Stoxx 600 since 2004 looks like this;



Europe has not exactly impressed with its earnings growth in the last 10 years, and its mainly explained by large weights of financial and industrial companies, while US has a much higher portion of tech, media and healthcare in S&P 500. In Europe the forecast for Stoxx600 EPS in 2018 was 26.80€ and its looks to be 26.20€, but still a decent 8% growth when comparted with 2017.

US companies have shown good earnings growth and are aggressively trimmed

To a large extend that explains the strong performance of US stocks in the 2010s as illustrated below;



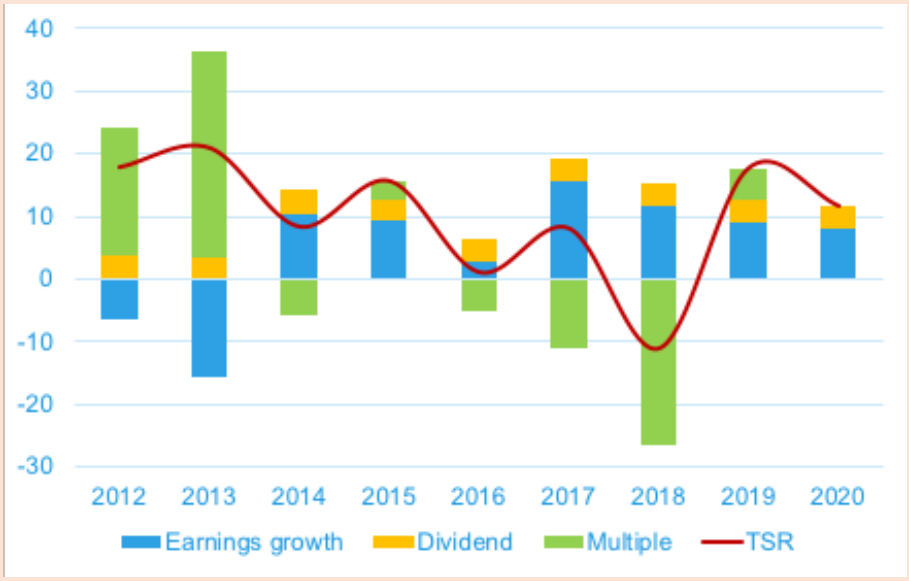
At the beginning of 2018 the expectations for S&P 500 EPS in 2018 was 146$ and it's likely to close the year at around 163$. The 146 $ number was made before the lower corporate tax rate in US was a reality.

When comparing stock market performance from year to year I find it useful to decompose the factors that drive performance;
The can be boiled down to earnings growth, dividend yield and valuation change – and when you add those three you get the total shareholder return. You can sophisticate it a bit more by calculating the change in 10-year bond yield relation to P/E level, but that has not be accurate since bond yields fell below 5%

Significant increase in risk preium in 2018 in Europe…

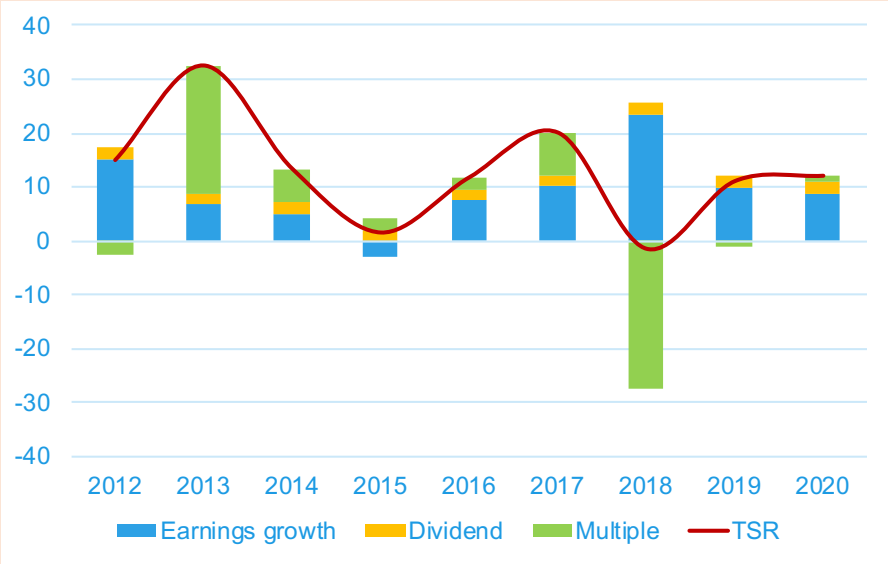
From the below figures you can see the multiple expansion in 2012-13 once it was clear for investors that central banks would buy bonds and supply liquidity until the economy was running by itself. Similarly, from 2016 investors gradually started to discount a normalization of monetary conditions as well as Brexit and other dysfunctionalities in the EU system

Stoxx600 TSR factors since 2012 and estimate towards 2020



…and even more in USA

S&P 500 TSR factors since 2012 and estimate towards 2020

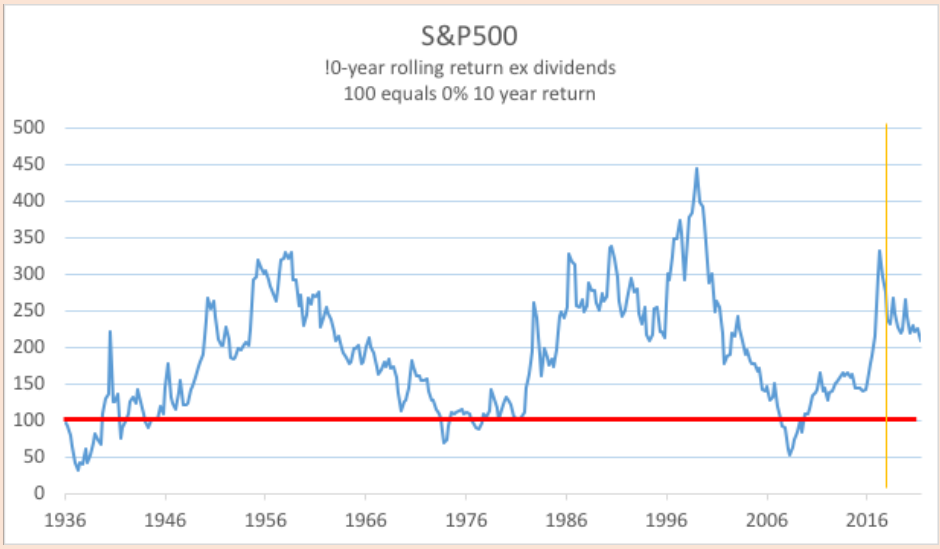


An observation: industry specialists overestimate by 5-8% when measured start of year to actual outcome, but the past 5 years accuracy has been better

The main price movements I follow are S&P 500, Stoxx600 and MSCI Asia Pacific. S&P 500 undoubtedly is the global drumbeater, but after 2016-18 performance I wouldn't be surprised to see US investors rebalance out of US and into Asia and a bit to Europe in 2019.

As the lows of 2008 are now 10 years old this stock market measure looks less 'bubbly'

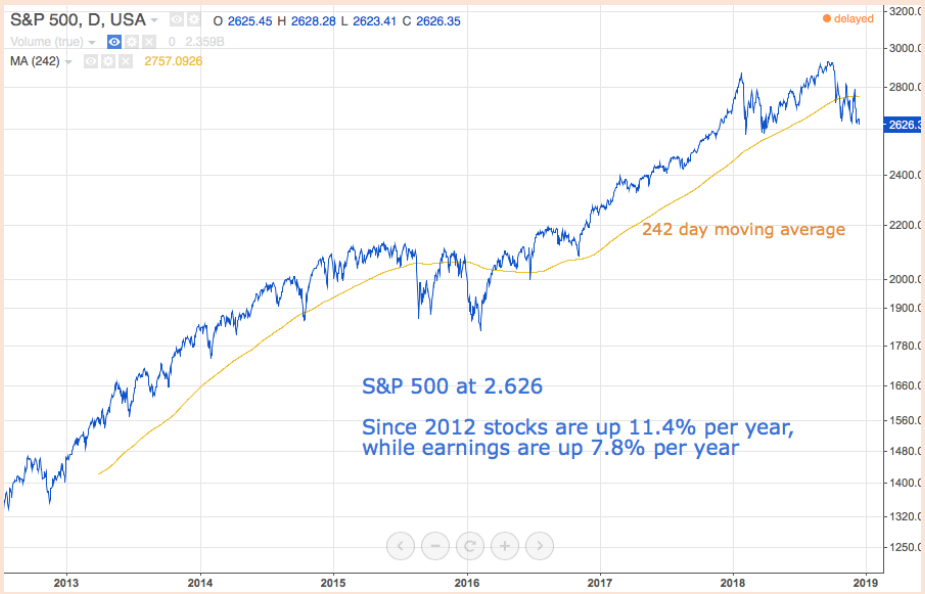
S&P 500 rolling 10 year price change since 1925.



Yellow line is end 2018 and forward curve is based on earnings growth with average P/E

US has run a bit ahead on fundamentals, but not to a dangerous level

S&P 500 since 2012 with 242 day moving average



There's around 242 trading days in a year and institutional investors have one year plans

Europe is seeing earnings growth going forward, however the performance since 2012 is nothing special

European stocks have been moving sideways since 2014 as earnings have been held back by poor performance in banks. In 2018 the trade war factor has had a negative impact on the automotive sector

Stoxx 600 since 2012 and 242 day moving average

Asia is the global production hub, so a victim to trade war jitters in 2018

Asia was a strong performer in 2016-17 based on rapid earnings growth in semiconductor and tech sectors, however the trade war has dampened the mood around the global production hub, and market is down 20% from peak

MSCI Asia Pacific since 2013 and 242 day moving average

How to navigate as investor in 2019

Middle of the road looks like 8% pace for stocks in 2019

2018 was by no means an easy year. In 2019 you have to be alert to all the economic signals and company updates for confirmation of a slow down or if it is just a cyclical downturn, in which case stocks will rally 10-15%

Be prepared to take your vehicle(s) to the roadside in some periods and in other periods give it full speed in the fastest lane

More specific I will use 2019 to detect which factors that generate alpha. Is Value style coming back for real or is Growth style still dominating the performance tables?

Value Style is close to 30 years most attractive

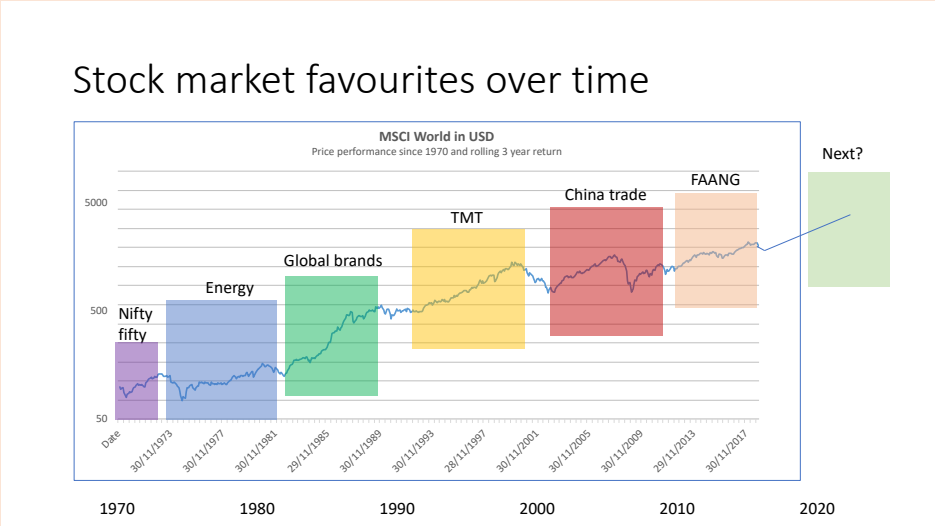
High long term relative earnings growth clusters outperform

Each period in the stock market has had their favorites and there's not a systematic way to predict which will be the next favorite. The common factor since 1969 between the periods in the figures on next page is **relative earnings growth**. In the 1970s oil companies made a bundle while other companies suffered from higher energy costs, the China trade period was driven by Chinese infrastructure investments that required raw materials from all over the planet. The only period with limited earnings growth (but high sales growth) was the TMT bubble. And we all know how that ended.

Within the next few years the next high earnings group will start to emerge and some should already be detected in 2019-20

The next high earnings growth cluster will start to emerge in 2019-20. For now FAANGs etc hold the yellow jersey

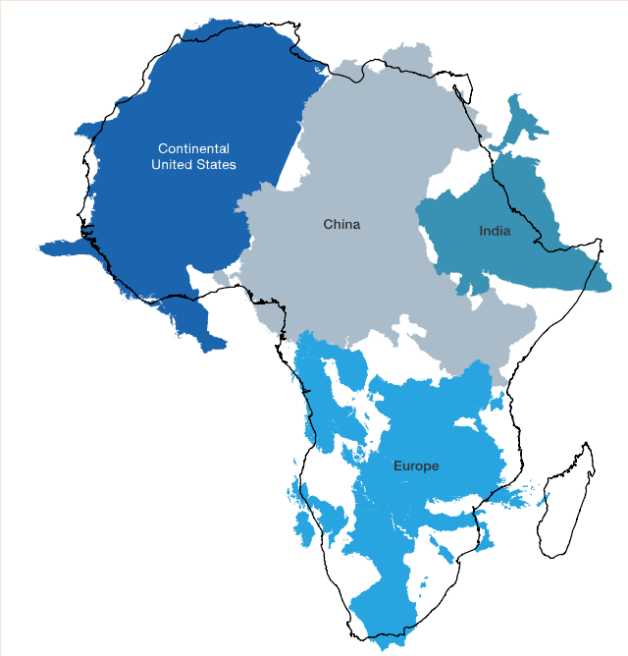
MSCI World since 1969 and best performing clusters



And just a final opportunity that might surprise on the upside despite many years of spluttering performance; Africa

Invest your time before you invest your money !

Africa will see the highest population growth in coming decades and there's a need for infrastructure (road, rail, education, healthcare etc). A potential good business opportunity, however the business culture and governance systems need more transparent standards to attract more capital. Africa is a huge opportunity in the long term and the continent is huge, so keep an eye on that.



Happy new year and enjoy the 2019 journey