Nordea View

October 2018: The story is not over

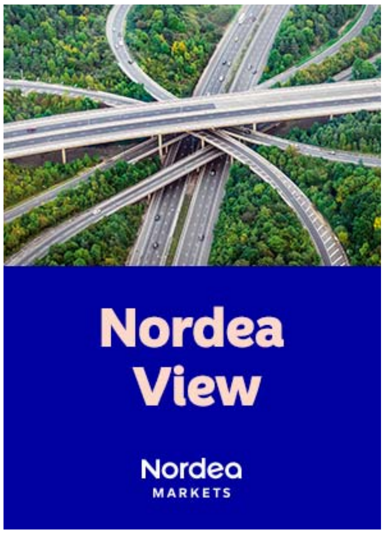
Higher US interest rates spurred by new signals from the Federal Reserve have triggered a sell-off in equity markets over the past two weeks. We have long held the view that such a correction should occur. The combination of slower growth, higher cost pressure, rising interest rates, a negative liquidity turnaround, record-high margin expectations and stretched valuations leaves little to no room for negative surprises. We see further downside for equities over the coming 6-9 months, despite acknowledging that stock markets are heavily oversold in the short term. The list of market moves indicating an investor shift to less risky assets is growing by the week, making us even more confident in advocating for defensive positioning. We therefore continue to advocate a value, late-cyclical bias, thereby maintaining a defensive sector tilt.

Nordea Markets - Analysts
Mikael Sarwe
Head of Market Strategy
mikael.sarwe@nordea.com

Carl Grapenfelt
Head of Market Research
carl.grapenfelt@nordea.com

Arvid Böhm
Head of Equity Strategy, Market Strategy
arvid.bohm@nordea.com

Martin Enlund
Chief FX Strategist
martin.enlund@nordea.com



Macro strategy: So far, so good

Most of our global macro and market predictions for 2018 have proven correct, even though it has been a rocky road until the recent market sell-off. We once again reiterate our negative stance on risky assets, which we first formulated in mid-May. The forward-looking business cycle has passed its peak and leading indicators suggest to us that the lost momentum should continue well into 2019. A weaker trend in real economic indicators is therefore imminent, some of which have already started to contract.

The rise in underlying inflation pressure, stemming from tight labour markets, is showing no signs of easing. We believe quite the contrary – and therefore that monetary policy risks being behind the curve. Rising real rates are another factor we need to add to our cocktail of a failing business cycle with too-lofty profit expectations. Even after the recent sell-off, we believe that the stock market still expects much too rosy a future – disappointments lie ahead.

Equities: New leadership to enhance alpha

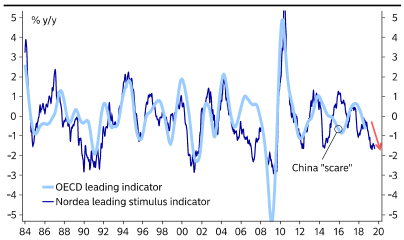
We still argue that equity markets are vulnerable to the margin disappointments that we foresee. In this report, we single out the US, given the FX headwind that still appears unacknowledged by consensus forecasters. We therefore revise our August conclusions (ie, take some profit from US outperformance) and argue that investors should underweight the US, based on relative valuation, revision and positioning grounds.

We also see clear signs that risk aversion continues to accelerate, following small-cap underperformance, cyclicals losing steam, and classic underweight traits such as expensiveness, low quality and estimate downgrades are being shunned. Leadership is also changing and we therefore still advocate for a distinct value bias, which is starting to bear fruit. We also advocate for late-cyclical rather than early-cyclical exposure and hence advise maintaining a defensive sector tilt. We are adamant, however, about not paying too much for stability, ie avoiding bond proxies, as quality stocks tend to struggle when interest rates rise.

Market theme: Risk on the rise

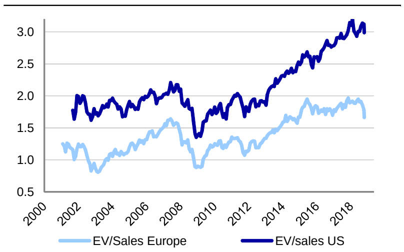
The recent rise in market risk comes as no surprise to us, as our multifactor analysis has indicated for some time that a normalisation of market volatility, at bare minimum, should be expected. We have pinpointed two possible triggers, at least one of which – seasonality – has now activated a rise in market volatility. The second trigger – softer momentum in the business cycle – is still in play. We have identified three factors to overweight, including low-risk and high-quality traits. Expensive stocks tend to underperform in periods of market uncertainty, thus we also advocate for adding a valuation dimension. Additionally, our ESG research suggests that paying more attention to ESG can help mitigate risk in turbulent markets and as such should grow in importance.

THE SLOWDOWN SHOULD CONTINUE



Source: Macrobond and Nordea

US VALUATIONS HAVE DECOUPLED



Source: Macrobond and Nordea

Macro strategy: So far, so good

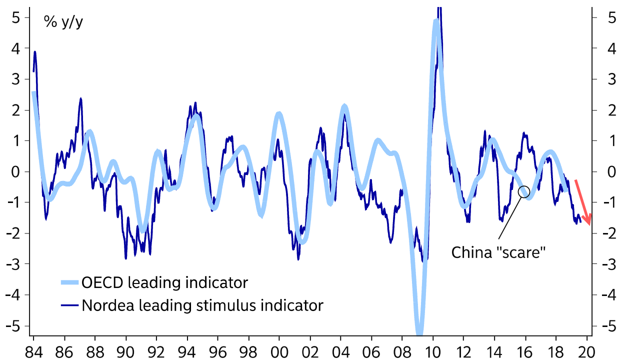
The forward-looking business cycle has passed its peak. Leading indicators suggest the lost momentum should continue well into 2019. A weaker trend in real economic indicators is therefore imminent, and some have already started to contract. The rise in underlying inflation pressures, stemming from tight labour markets, shows no indication of easing; in fact, the reverse. Monetary policy risks being behind the curve. In other words, rising real rates are another factor we need to add to our cocktail of a failing business cycle and too lofty profit expectations.

Welcome back, Mr Volatility

Global slowdown, higher yields and central bank liquidity turnaround behind the volatility increase in 2018

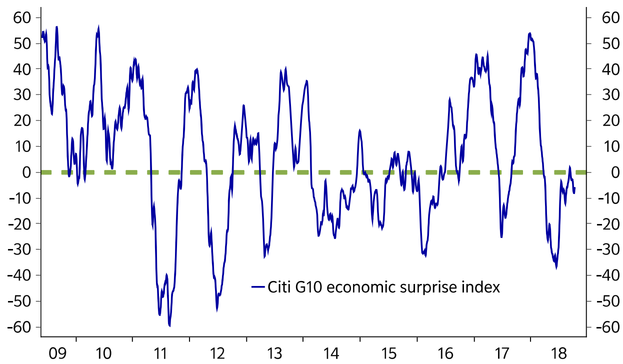
Rising interest rates since 2016 made us believe ahead of 2018 that the global manufacturing cycle would turn down and that macro surprises would move to negative territory and, on average, stay there. Together with global central bank liquidity drying up and our belief that the Federal Reserve would deliver more rate hikes than discounted by the market, we envisaged more volatile markets for risky assets compared with 2017. This has been a correct assumption. Furthermore, we predicted a comeback for the USD due to the relative US outlook regarding growth, inflation and monetary policy. The USD comeback is ongoing and has also meant that US assets have, until last week, been doing well.

GLOBAL MANUFACTURING SLOWDOWN SHOULD CONTINUE



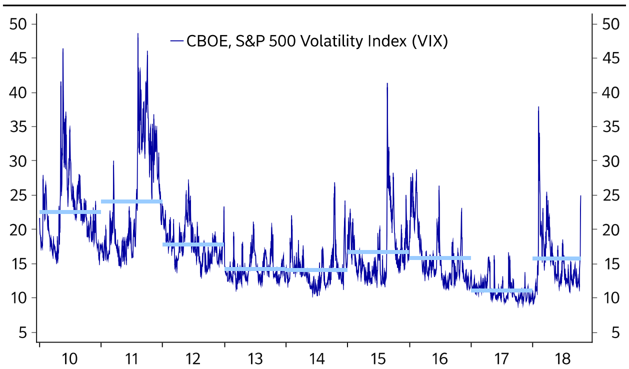
Source: Macrobond and Nordea

ECONOMIC SURPRISES HAVE BEEN NEGATIVE



Source: Macrobond and Nordea

2018 HAS BEEN A VOLATILITY COMEBACK YEAR



Source: Macrobond and Nordea

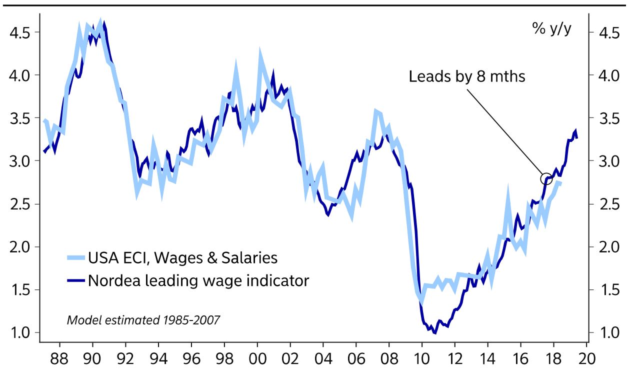
2018 HAS BEEN A USD COMEBACK YEAR

Source: Macrobond and Nordea

Upside wage pressure increasing

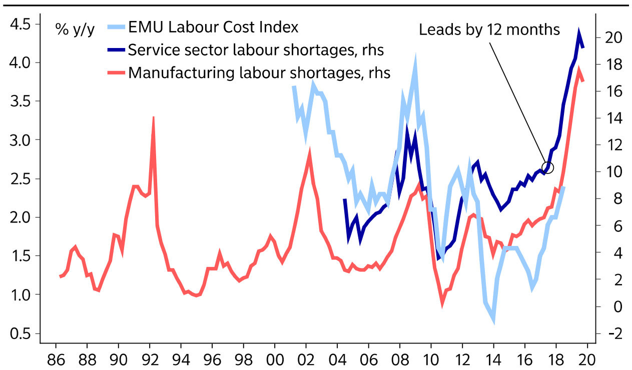
In April this year, we noted clear signs of upside wage pressure emerging in the US and also in the Eurozone with a lag, for both cyclical and structural reasons. We concluded that the US 10-year yield would grind higher, with a target of 3.5% possibly as early as late 2018, and over time also drag up European rates. Higher underlying inflation pressure through rising wage growth means that central banks should be less inclined to react to the slowdown scenario we envisage.

US WAGE PRESSURE IS RISING



Source: Macrobond and Nordea

EURO AREA LABOUR SHORTAGE IS RECORD HIGH

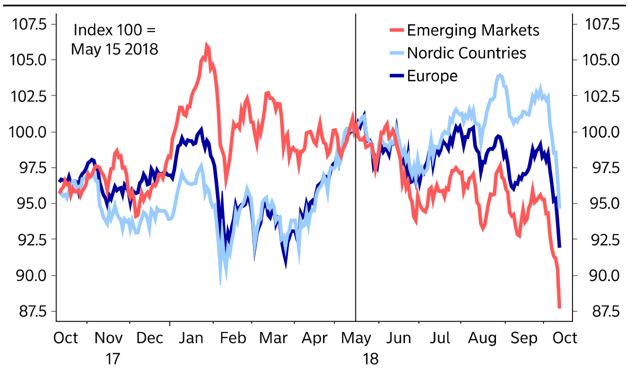


Source: Macrobond and Nordea

Profit margins should get squeezed from lower growth and higher costs

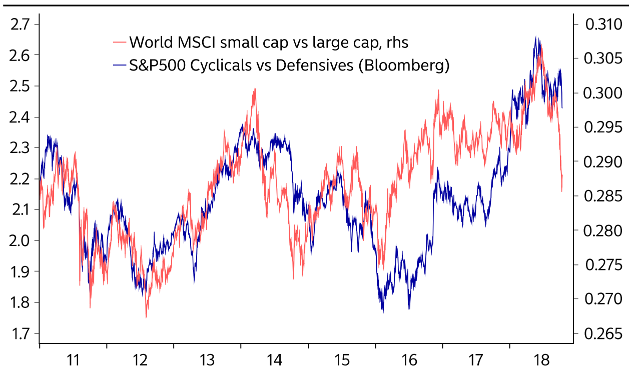
When we published our first Nordea View in mid-May, we took these implications one step further and recommended a more defensive, underweight position in risky assets including equities. In our view, slower global manufacturing growth, rising wage costs, higher interest rates and worsening liquidity conditions, taken together with positioning and stretched equity valuations on top of already record-high profit margin expectations, all indicated a negatively skewed risk/reward situation. Since then, MSCI Europe has fallen by 7%, MSCI Emerging Markets by 11% and MSCI Nordics by some 5% in local currency terms (in USD terms they are down 9%, 14% and 7%, respectively). Over the same period, US cyclical stocks have underperformed defensive ones to the tune of 7%. In June we added that it was time to reduce small cap exposure, because of the higher wage share of costs and liquidity risks. Since then, global small caps have underperformed large caps by around 5%.

MSCI TOTAL RETURN, LOCAL CURRENCY



Source: Macrobond and Nordea

SMALL CAPS AND CYCLICALS UNDERPERFORMANCE



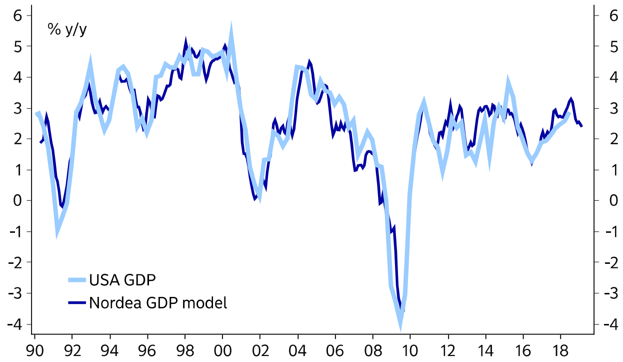
Source: Macrobond and Nordea

We have been somewhat surprised by the strength of the US economy

Possibly some would call this a "slam dunk". Although we would not necessarily disagree, it has been a rocky road ahead of the recent sell-off. Many would probably argue that the jury is still out and there could still be some “risk on” in the air. Admittedly, there are some chinks in our shining armour. We expected an outperformance for value stocks that until recently had not materialised, but the most obvious chink is clearly spelled 'U S A'.

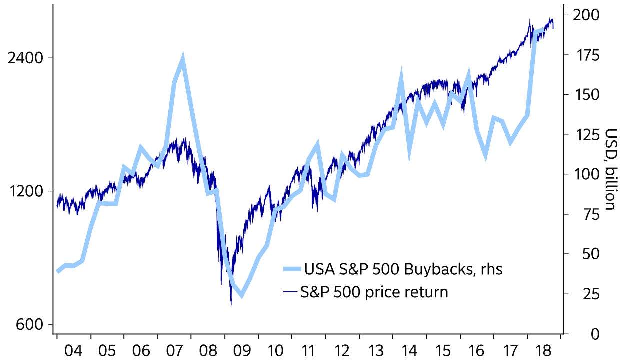
We have been surprised by the very strong US stock market and that the global growth slowdown has not leaked back to US growth numbers. Until last week, it has been costly to underestimate Trump and his pro-cyclical fiscal policy, not to mention the effects of the huge equity buyback programmes (a double-edged sword that has prolonged the bull market, but historically has also been a late-cyclical sign of a stock market top in the making). Over the last 20 years there has basically never been such a long period with the US stock market powering ahead so strongly at the same time as the rest of the world is trending down, the way it has since late January 2018. It cannot continue forever. Something has to give. We still expect that the force of business cycle gravity will now turn to the US economy and US assets. Maybe we have just seen the start of that.

STRONG US ECONOMY AT PRESENT



Source: Macrobond and Nordea

BUYBACKS SURPASSING 2007 LEVELS

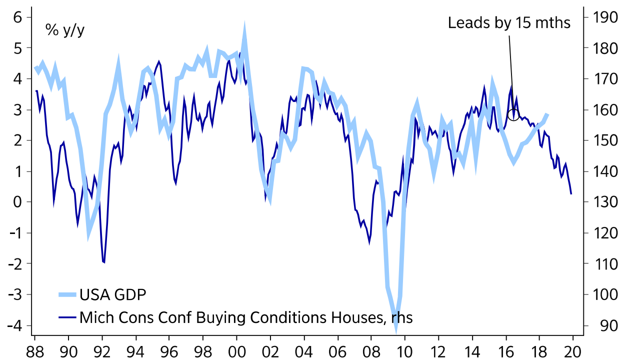


Source: Macrobond and Nordea

Many signs of a nearing slowdown in the US

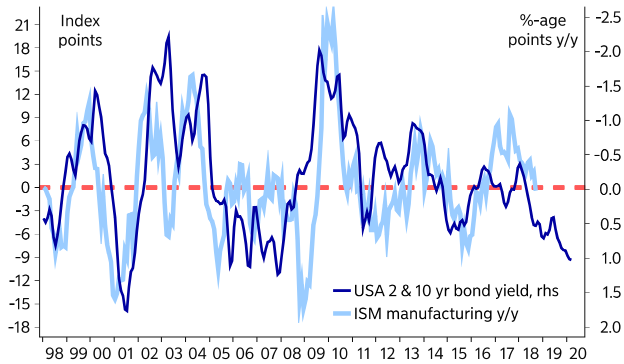
The reason for this, as we pointed out in the August issue of Nordea View, is that it has historically taken about 1.5 years for monetary policy tightening to really weigh on the leading indicators of the US economy, which would roughly correspond to now. There are already a number of such gauges that have come down, without the stock market taking notice. The households' view on the housing market is one important example because, as the old US saying goes, "as goes housing, so goes the economy". A number of business surveys, such as the Philly Fed, the Empire future outlook and the Chicago PMI, have lost momentum. The US stock market is missing a drop in the ever-important ISM, which is still hovering around all-time highs.

US HOUSE BUYING CONDITIONS AND GDP



Source: Macrobond and Nordea

RISING INTEREST RATES SHOULD LEAD TO FALLING ISM



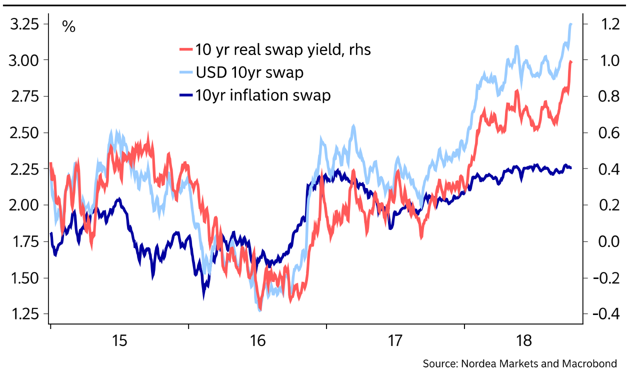
Source: Macrobond and Nordea

Fed signals increased importance of financial imbalances for monetary policy

We have said before that it is crucial for our continued negative stance on the equity market that the ISM drops towards 50 by spring next year, which our indicators still point to. New information from the Fed also has the potential to crucially affect stock market valuations. It has partly toned down its inflation focus somewhat. More importantly, since August there have been a number of indications that the Fed has introduced financial imbalances and asset valuations (where it sees stock market valuations as "elevated") as more pronounced indicators for monetary policy.

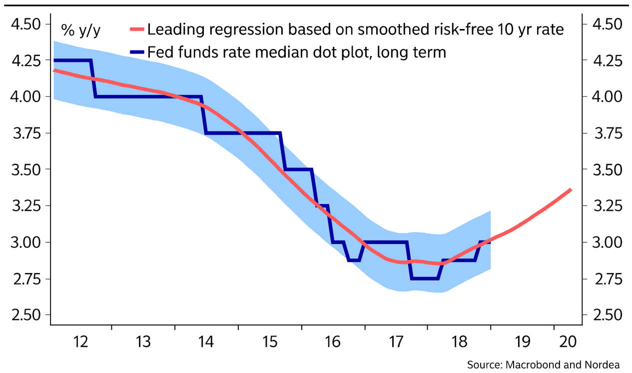
Powell and Brainard have both noted that the short-run neutral rate should be higher than the longer-term 3% level, taking into account those two factors and also fiscal policy. In other words, they are signalling a risk of higher real rates going forward, which the money markets have started to pick up on, and the path of which should be less sensitive to falling stock markets than previously under Yellen/Bernanke/Greenspan. The new "Fed put" could have a strike level that is much deeper out of the money than the old one.

FED SIGNALS TRIGGER RISING REAL INTEREST RATES



Source: Macrobond and Nordea

FED'S VIEW ON NEUTRAL RATE SHOULD RISE



Source: Macrobond and Nordea

On top of this, we reiterate our view that wage growth should continue higher in both the US and Eurozone, creating an underlying inflation foundation for higher rates also in Europe over time. Our macroeconomists have looked into a number of central banks' reaction functions and have come to the conclusion that a shift towards rate hikes could be on the way more broadly around the world. Central banks are probably starting to feel that they are behind the curve, even though they would not publicly admit it. For more on this, please read 'Return to your rules, please!'. Higher yields would, of course, challenge asset valuations in general and top multiple trading stocks in particular.

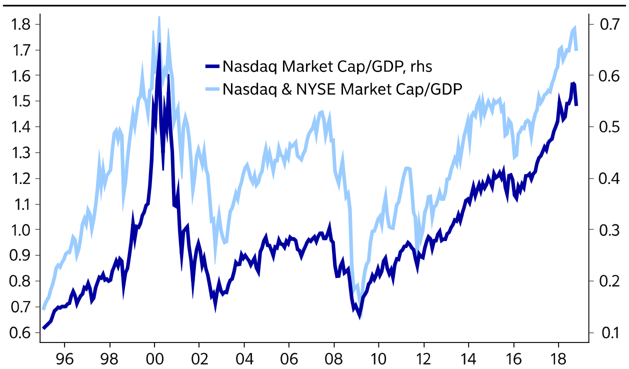
We keep our negative tilt to risky assets

All in all, we believe that the global manufacturing slowdown will continue into 2019, momentum in US leading indicators will turn down, wage growth will rise further and interest rates will grind higher. We therefore believe that top-line growth will slow markedly and that stock market valuations will have a hard time swallowing the downward revisions that we expect for profit margins. We keep our negative tilt towards risky assets, despite acknowledging that stock markets are very oversold in the short term. The recent rise in volatility is, in that sense, no surprise to us.

Negative risk factors outweigh positive

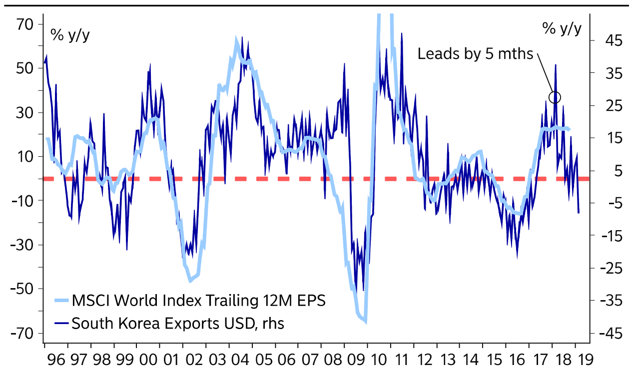
We still do not see a recession (real short rates are still too low and the positive capex cycle helps) and so we do not expect a market crash, but rather a correction similar to the 15-20% setback in global equities in 2015-16. There are positive differences to that period, most notably no oil price collapse, China looking less bad and fiscal policy stimuli in the US, but we believe the negative differences outnumber the positive ones. The negative differences are: much higher cost pressure; higher interest rates; a reduction in central bank balance sheets; higher equity valuations; very high profit margin expectations; and escalated political risks.

VERY HIGH US MARKET CAP/GDP LEVELS



Source: Macrobond and Nordea

GLOBAL EARNINGS MOMENTUM SHOULD TURN DOWN



Source: Macrobond and Nordea

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Equities: New leadership to enhance alpha

We continue to argue that equity markets are vulnerable to the margin disappointments we foresee. In this report we single out the US given the FX headwind that still appears not to be captured by consensus forecasters. We therefore revise our August conclusions (take some profit from US outperformance) and argue that investors should underweight the US, based on relative valuation, revision and positioning grounds. We also see clear signs that risk aversion continues to accelerate, following small cap underperformance, cyclicals losing steam, and classic underweight traits such as expensiveness, low quality and estimate downgrades being shunned. Leadership is also changing and we therefore continue to advocate for a distinct value bias, which is starting to bear fruit. We also advocate for late cyclical rather than early cyclical exposure and would advise in favour of maintaining a defensive sector tilt. We are adamant, however, about not paying too much for stability, ie avoiding bond proxies, as quality stocks tend to struggle when interest rates rise.

We can now add more canaries in the coalmine to the list we compiled in our first Nordea View

In our first Nordea View (Classic overconfidence), we listed a number of canaries in the coalmine. We have subsequently added a number of additional factors that suggested investors became more risk-averse as the year progressed. The change in leadership now appears to be in the making.

The first market to show investors moving inwards on the risk scale (ie becoming more risk averse) was European Investment Grade credit spreads, which widened in the spring. Shortly thereafter, as the Fed continued to shrink its balance sheet, emerging market currencies wobbled, leading to pretty broad-based emerging market equity underperformance versus developed markets. And this has persisted. By mid-year defensives regained some ground relative to cyclicals, while size started to matter more, with small caps starting to underperform large caps.

Small cap underperformance has intensified in recent weeks, with subsequent weakness in Nasdaq versus the S&P 500

Over the past four to six weeks, small cap underperformance has intensified globally, and most recently we have also seen weakness in Nasdaq versus the S&P 500, again signalling a change in leadership. When we see expensive stocks underperforming and cheap stocks in Europe no longer underperforming, we can spot small signs that valuations appear to be growing in importance. The value factor that has seen the greatest recovery relative to the market is high dividend yield – the lowest risk value metric. The final piece of the puzzle is a more broadly based MSCI series of value versus growth, which also indicates a relative value recovery.

We note with interest that earnings revision momentum has not yielded any alpha since April, with regards to overweights in Europe. We have, however, witnessed earnings and sales downgrades still being punished severely. Given our expectation that earnings uncertainty is bound to pick up in the coming months, we advocate treating the revision factor with caution, especially in the search for longs. We would instead try to identify reasonably priced quality stocks with reasonable expectations.

When looking further under the hood utilising our proprietary quant series in Europe (mid-small caps) it appears that investors are getting more worried about what not to own. We make this claim as we see increasing evidence that classic underweight strategies such as expensive traits, low quality and downgrades are all seeing accelerating underperformance. On the flip side, we find it intriguing that the inverse has not materialised. This suggests that investors have not yet decided what to own.

Valuation focus remains important in stock picking though

Looking ahead we still advocate the importance of maintaining a valuation focus in stock picking, given the relatively attractive valuation of the value style and our continued belief that global interest rates will grind further north, since this theoretically suggests that valuation differences should narrow.

Even though small caps have already underperformed materially since our June prediction, we are not prepared to call a reversal just yet, given the prevailing relative estimate and liquidity risks. Additionally, small caps are often perceived as growth stocks, and interest rates grinding north gives us yet another argument to remain cautious. We still advocate for late cyclical rather than early cyclical exposure given our view on the capex cycle (see our last report) and we would maintain a defensive sector tilt. We are adamant, however, about not paying too much for stability, ie avoiding bond proxies, as quality stocks tend to struggle when interest rates rise.

Time to underweight the US

We see the US underperforming based on relative valuation spread…

…relative estimate risks, including currency headwinds not being captured by consensus…

…and positioning towards US risky assets being extreme

The valuation decoupling of North America (read the US) from Asia and Europe leaves us even more convinced that it is not a matter of if but rather when the US will fall from grace. Our belief stands on the relative valuation difference on EV/sales having not been this great since 2004 and that the strength in the dollar index should hamper further US relative earnings revision strength. When we add that positioning is extremely biased to the US, our conviction is strengthened. If we argued for taking some chips off the US table in our August update, we are now advocating going underweight on that market tactically in favour of Europe in particular. The final piece of the puzzle would be a reversal of the dollar strength, which we forecast could materialise as we approach the new year and could represent the trigger for emerging markets.

We still see aggregated margin expectations in the US being moderated and given that the spread between 2018 and 2019 levels has widened, we remain convinced that margin forecasts are too high for next year. It is true that analysts have a propensity to overestimate profitability and a valid question is: why should we care about this now? We argue that there are two major differences between now and the post crises setup (2010-18). Falling interest rates (implied cost of capital) and attractive valuation offered absorption during 2010-16, whereas top-line upgrades meant that, despite slight margin disappointments, earnings growth remained solid and was able to absorb the margin forecast downward adjustments.

We would struggle to see margin forecasts downgrades being absorbed by the market

We consider the situation today very different. We do not see sales growth enabling overall forecast upgrades, given our belief of slowing global growth. The other absorption well (valuation and falling rates) is non-existent since interest rates are rising and global (median) EV/sales multiples remain in uncharted territory.

This P/E matrix illustrates that exponentially greater valuation differences are warranted when you apply a lower cost of capital

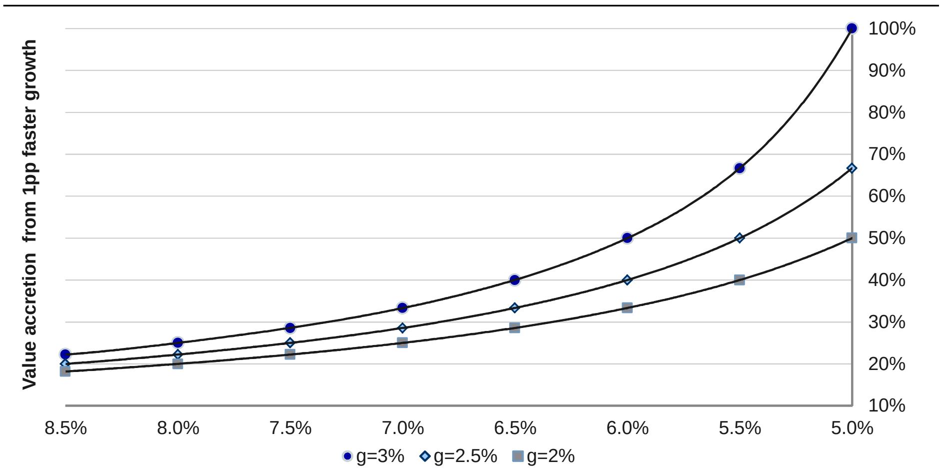
VALUATION, COE AND GROWTH IMPACT ON VALUATION ACCORDING TO GORDON

Growth (g)	Discount Factor (Cost of equity) 9.0%	8.5%	8.0%	7.5%	7.0%	6.5%	6.0%	5.5%	5.0%
3.5%	13.6	15.0	16.7	18.8	21.4	25.0	30.0	37.5	50.0
3.0%	12.5	13.6	15.0	16.7	18.8	21.4	25.0	30.0	37.5
2.5%	11.5	12.5	13.6	15.0	16.7	18.8	21.4	25.0	30.0
2.0%	10.7	11.5	12.5	13.6	15.0	16.7	18.8	21.4	25.0
1.5%	10.0	10.7	11.5	12.5	13.6	15.0	16.7	18.8	21.4

Source: Nordea

Rising cost of capital (following higher interest rates) should, in theory, bring about both multiple contraction and compression (smaller valuation differences between value and growth stocks)

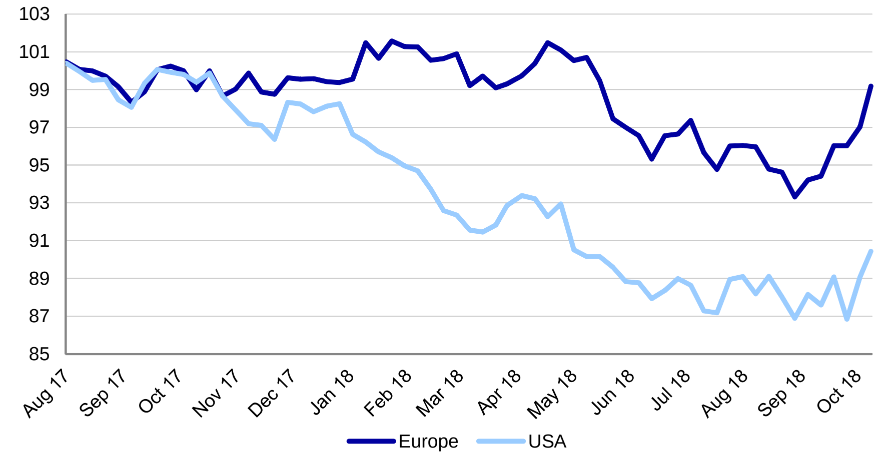
AS THE DISCOUNT RATE RISES WE WOULD EXPECT VALUATION DIFFERENCES TO NARROW



Source: Nordea

Is value investing back in vogue?

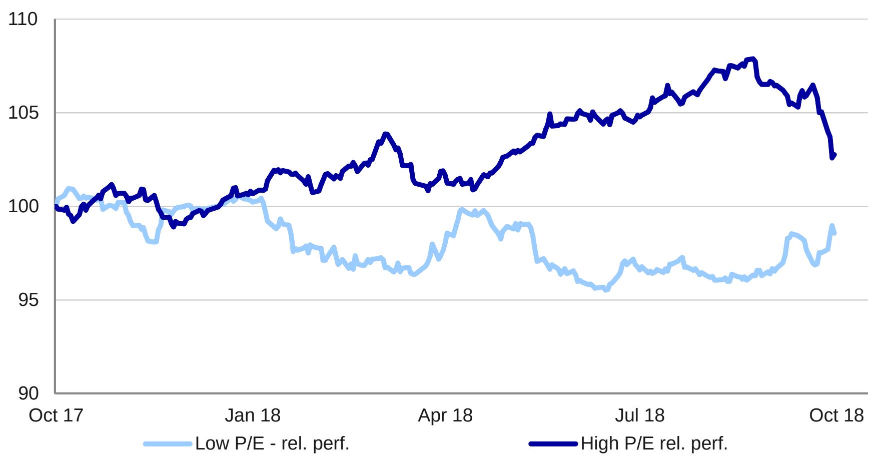
RELATIVE PERFORMANCE (TSR) OF MSCI VALUE VS GROWTH



Source: FactSet and Nordea

Finally expensive stocks are getting hit, while the cheap end is no longer sliding

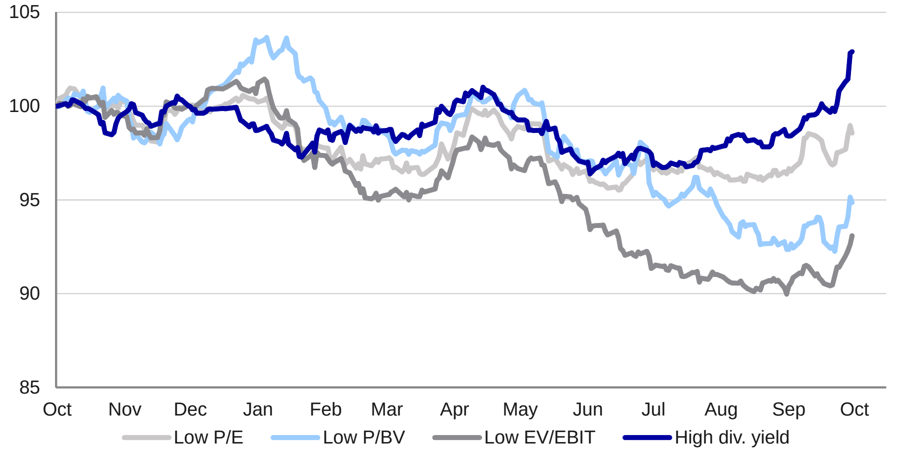
EXPENSIVE VS INEXPENSIVE STOCKS IN EUROPE (MID-SMALL CAPS)



Source: FactSet and Nordea

High dividend yield appears to be leading the value comeback in Europe

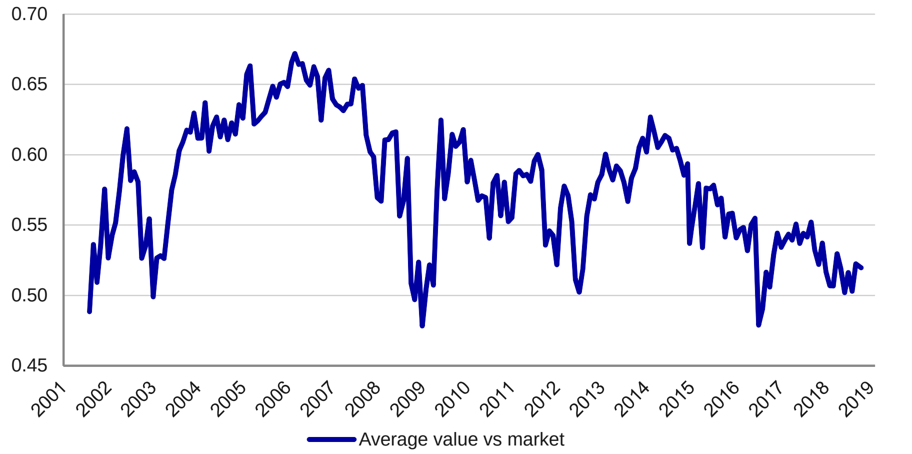
VALUE METRICS SHOW SIGNS OF LIFE AS DIVIDENDS LEAD THE WAY



Source: FactSet and Nordea

We argue that 2001 is a better comparison than 2007 from a relative valuation standpoint

EUROPEAN (MID-SMALL CAP) VALUE BASKET STILL ON SALE

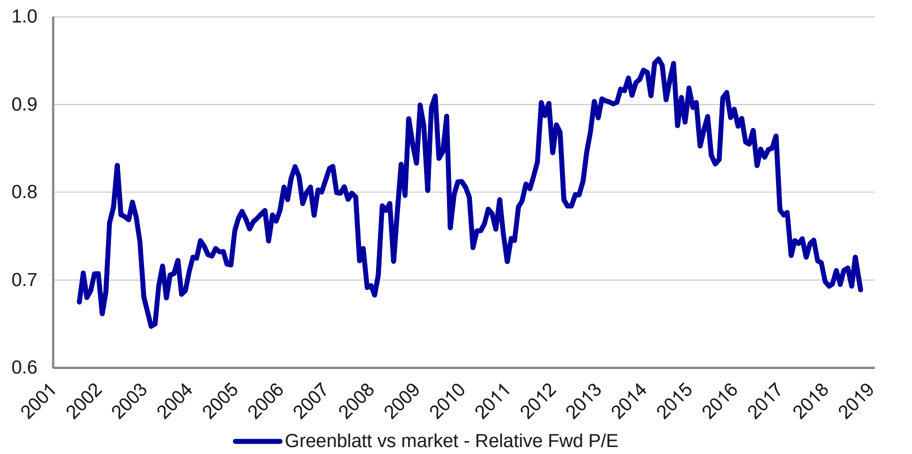


Source: FactSet and Nordea

Our value-quality hybrid is at levels at which investors have historically received goods odds for buying reasonably priced quality stocks

We advise investors to search among these characteristics coupled with an eye for containing the estimate risk

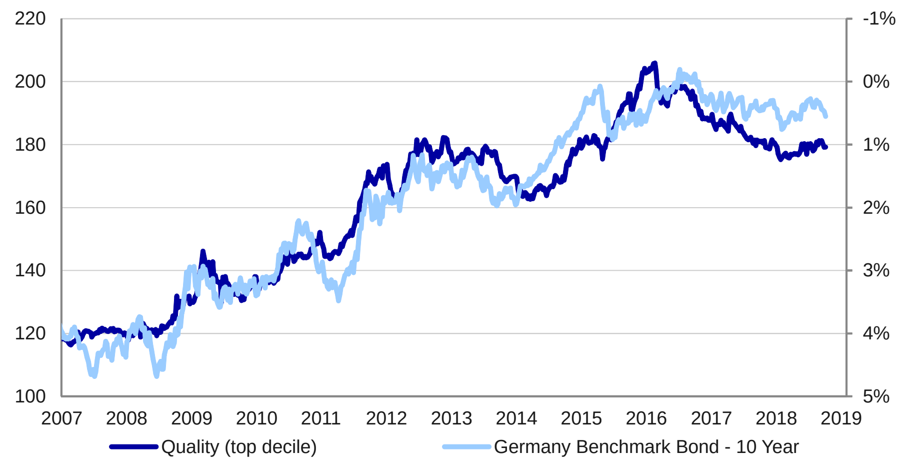
RELATIVE 12-MONTH FORWARD P/E (MEDIAN) OF GREENBLATT BASKET VERSUS MARKET



Source: FactSet and Nordea

Although we like the defensive attributes within quality, we are adamant about not paying too high a multiple given our view that interest rates are grinding higher

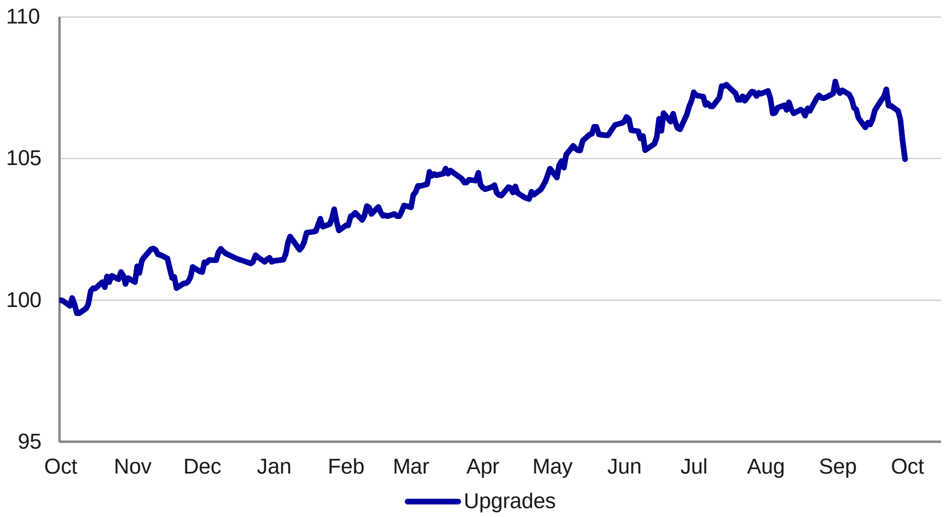
RISING INTEREST RATES IS OFTEN ASSOCIATED WITH RELATIVE WEAKNESS IN QUALITY



Source: FactSet and Nordea

Given our expectation that earnings uncertainty is bound to pick up in the coming months, we advocate treating the revision favour with caution, especially in the search for longs

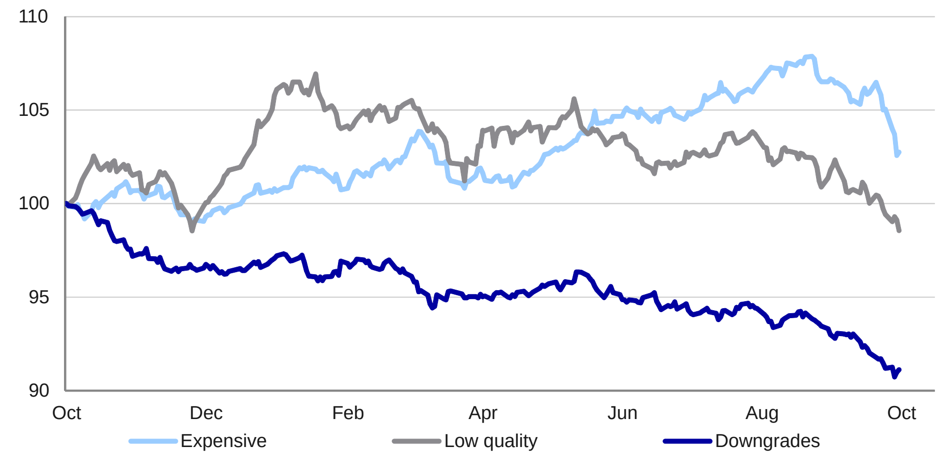
REVISION MOMENTUM HAS NOT YIELDED ANY ALPHA SINCE JUNE



Source: FactSet and Nordea

Accelerating underperformance for classic underweight traits is a sign of investors worrying more about what not to own in Europe (mid-small cap)

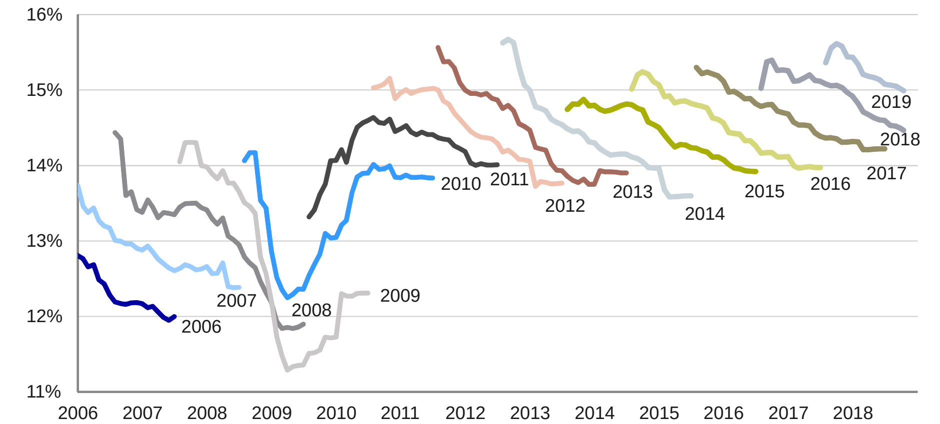
CLASSIC UNDERWEIGHT TRAITS ARE SHOWING ACCELERATING UNDERPERFORMANCE



Source: Company data and Nordea estimates

We are becoming increasingly concerned about the 2019 margin outlook, given that analysts are expecting an acceleration in the improvements versus just six months ago (the gap between the 2018 and 2019 lines is widening)

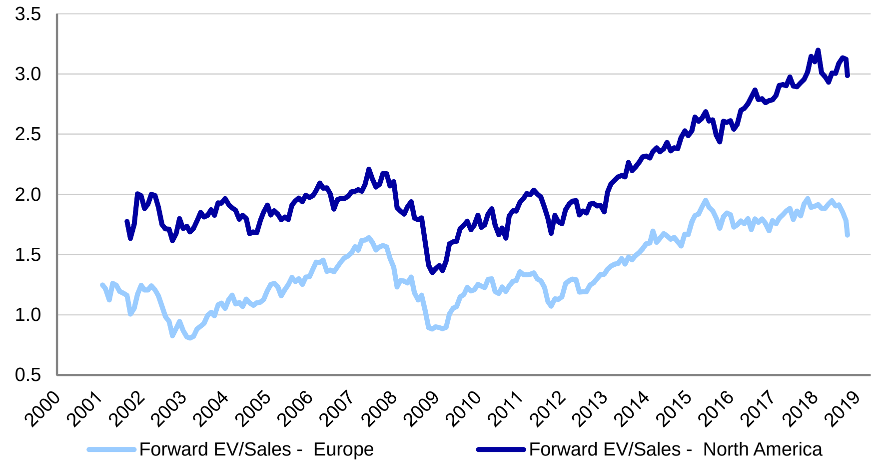
AGGREGATED EBIT MARGIN REVISION TRENDS FOR THE US



Source: FactSet and Nordea

We deem the US to be sensitive to the margin- and FX-driven estimate disappointments we foresee

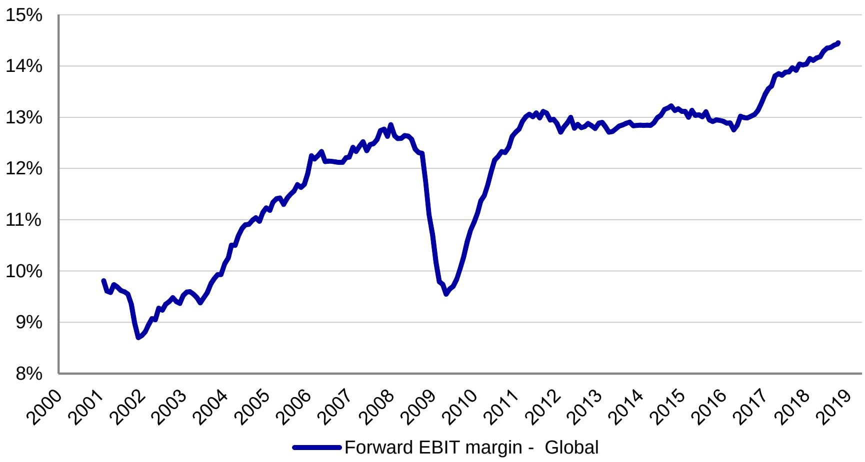
US EV/SALES DECOUPLE FROM EUROPE TO THE GREATEST DEGREE SINCE 2004



Source: FactSet and Nordea

Rising cost pressure and slower top-line growth coupled with the fact that analysts tend to overestimate profitability leaves us convinced that margin forecasts need to be shaved

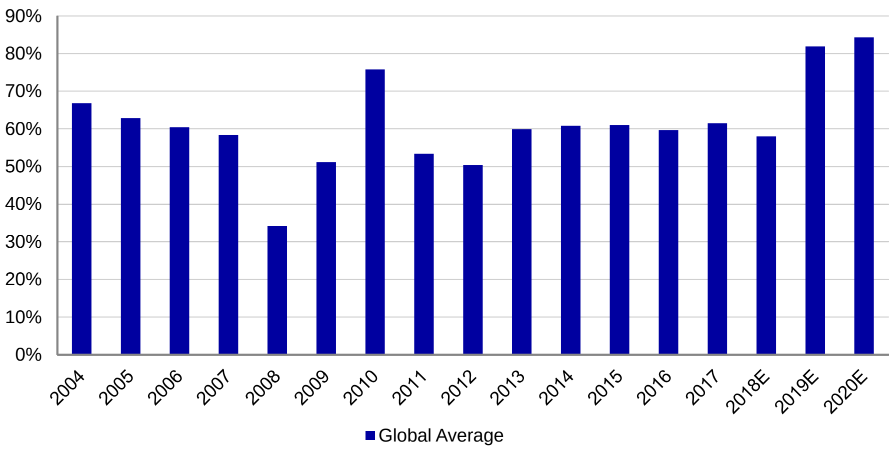
WHAT MULTIPLE WOULD YOU LIKE TO PAY FOR THESE EXPECTATIONS?



Source: Company data and Nordea estimates

This chart convinces us that margin expectations are too elevated for the coming years

ANALYSTS STILL EXPECT MORE THAN 80% OF COMPANIES TO IMPROVE MARGINS IN 2019



Source: FactSet and Nordea

This section has been produced by the Nordea Markets Independent Research unit.

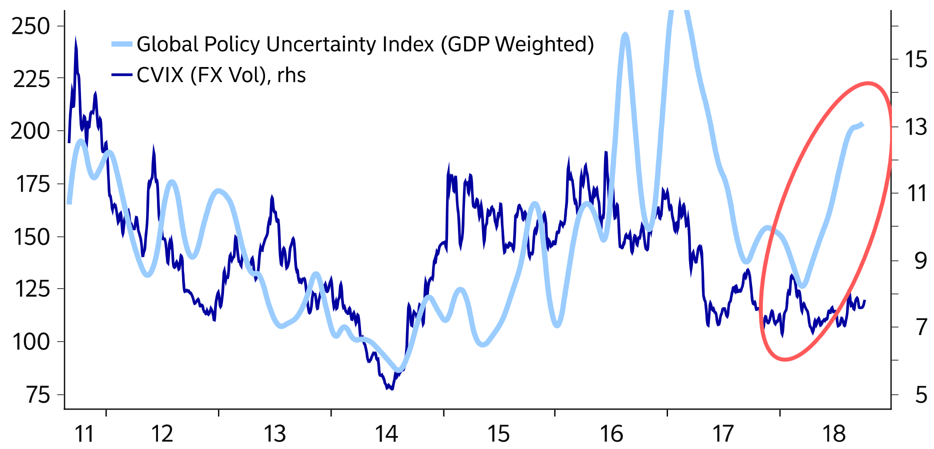
Risk on the rise

The recent rise of market risk comes as no surprise to us. Instead, it had been the absence thereof that we found puzzling. Our multifactor analysis indicated that at least a normalisation of market volatility should be expected. We pinpointed two possible triggers, of which at least one – seasonality – has now incited a rise in market volatility. The second trigger – softer momentum in the business cycle – indicates that the rise in market risk should persist for some time ahead. Therefore, we argue that strategies that improve a portfolio's risk/reward should be implemented. We identify three factors to overweight and one additional overlay.

Absence of volatility was the surprise, not its reoccurrence

Given the trade disputes, debt issues, a looming Brexit and a forward-looking business cycle that is rolling over, the absence of market volatility until very recently was a true conundrum. As we pinpointed back in September (Seven reasons why cross asset volatility is (too) low), a multifactor analysis suggested that market volatility was set to rise. A flattening US yield curve normally heightens equity and FX market volatility. A rise in fiscal deficits and lower USD reserve liquidity imply a rise in bond and FX volatility, respectively. When adding the sharp rise in perceived global policy uncertainty, the low market volatility was, and to some extent still is, a conundrum.

GLOBAL POLICY UNCERTAINTY POINTS TO HIGHER FX VOLATILITY

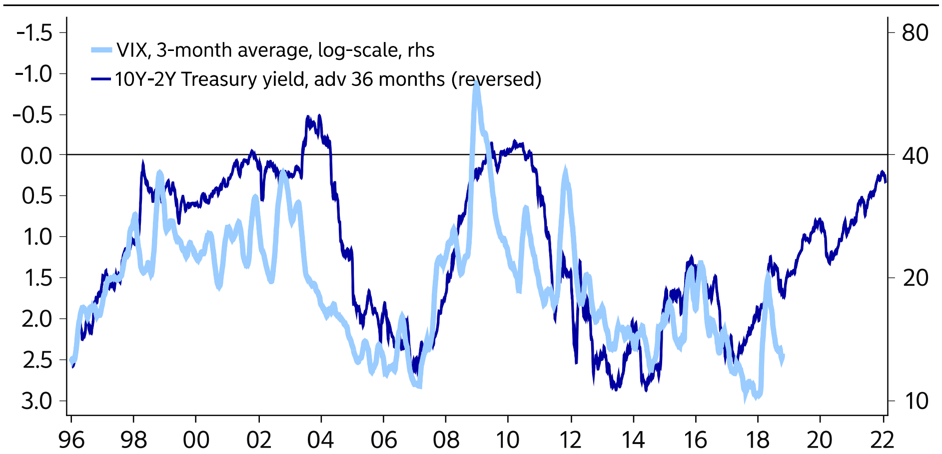


Source: Macrobond, Nordea

The VIX has done more than a mere mean reversion

In recent weeks, equity and bond volatility started to reverse. VIX traded at around 12 a month ago and is now at 23, a six-month high. Hence, mean reversion has occurred, and the index is even trading somewhat above the long-term average of just below 20.

US YIELD CURVE POINTS TO HIGHER EQUITY MARKET VOLATILITY

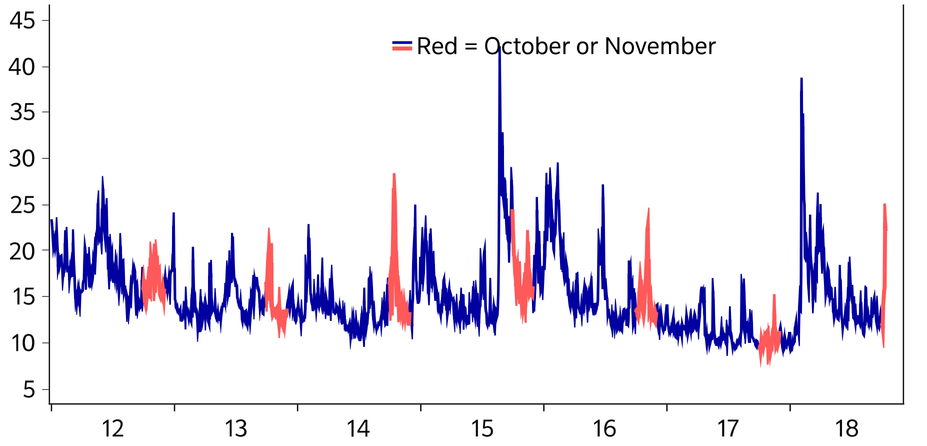


Source: Macrobond, Nordea

Still short of the February spike

So far, the jump in the VIX falls short of the spike from February, a risk scenario we highlighted as the market was as short in the VIX positioning in September as it was at the end of 2017. Although the fundamentals are in place, we argue that a trigger is probably needed for market volatility to rise across major asset classes. The reason for the higher volatility seen over the past couple of weeks is possibly a seasonal factor in October and November. For lasting normalisation of market risk (ie higher volatility), the perceived stability of underlying growth needs to be challenged.

SEASONALITY TRIGGERING EQUITY MARKET VOLATILITY

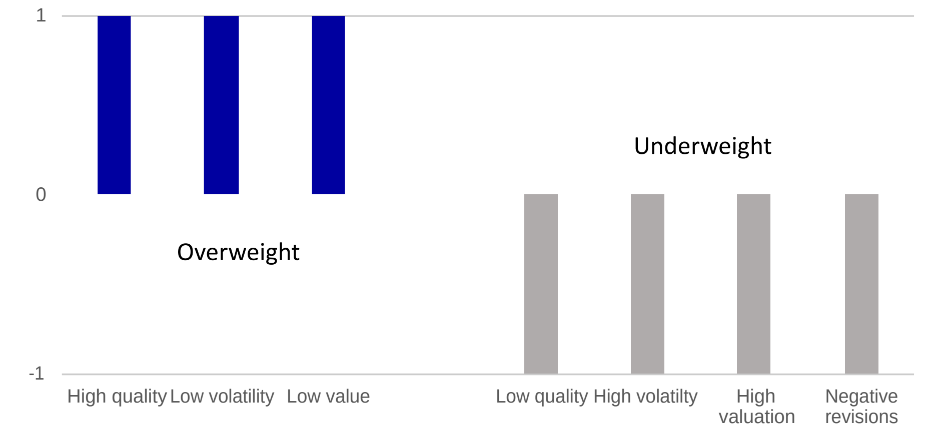


Source: Macrobond, Nordea

Quality, low volatility and low multiples are sheltering asset value

As we have described in the macro section, the retraction of the US manufacturing sector momentum should qualify as such a trigger. If this were to evolve into a sudden and sharp rise in market volatility, the appetite for risk would be lost. Risky assets would suffer the most, with credit spreads and equity prices taking the biggest hit. Buying out-of-the-money puts would certainly be the most straightforward strategy to protect asset value in a portfolio. However, our analysis also shows that stocks characterised as being of high quality, low volatility and inexpensive (especially relative to the rest of the market) normally outperform the rest of the market. We find that the underperformers have the opposite three characteristics, as well as negative revisions (of estimates and recommendation).

EQUITY ALLOCATION IN TIMES OF RISING VOLATILITY



Source: FactSet, Nordea

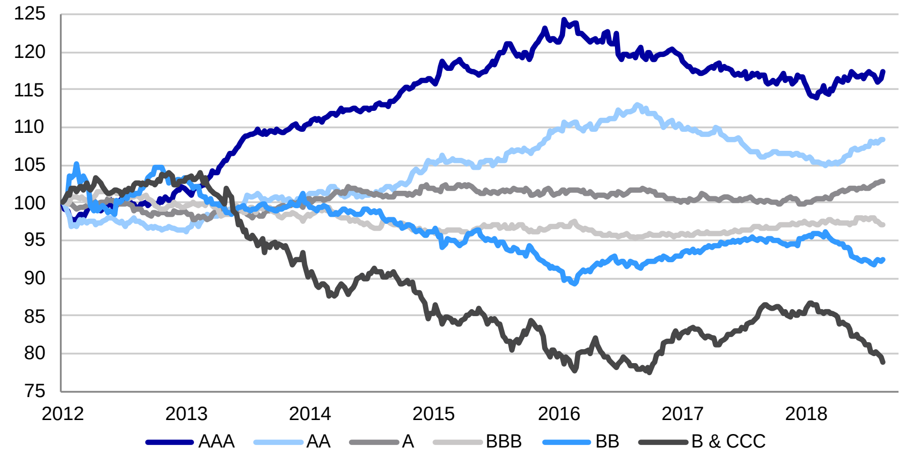
The recent increase in market volatility and the stock market correction have so far confirmed that these market characteristics are valid.

ESG protects asset value and enhances performance

Stocks with high ESG ratings outperform

In addition to the traditional factor analysis, our ongoing ESG research adds further insight into the risk/reward of capital allocation. We note that Europe appears to be at the forefront with regards to ESG ratings being reflected in equity returns. Statistical evidence indicates that stocks with high ESG ratings (ie companies with better ESG performance) outperform stocks with low ESG ratings. Strong alpha can also be created by playing the theme of companies that are improving their ESG ratings relative to those that are seeing a deterioration, regardless of the starting point. These findings are significant in Europe, but not in the US market so far.

RELATIVE PERFORMANCE PER ESG RATING - EUROPE

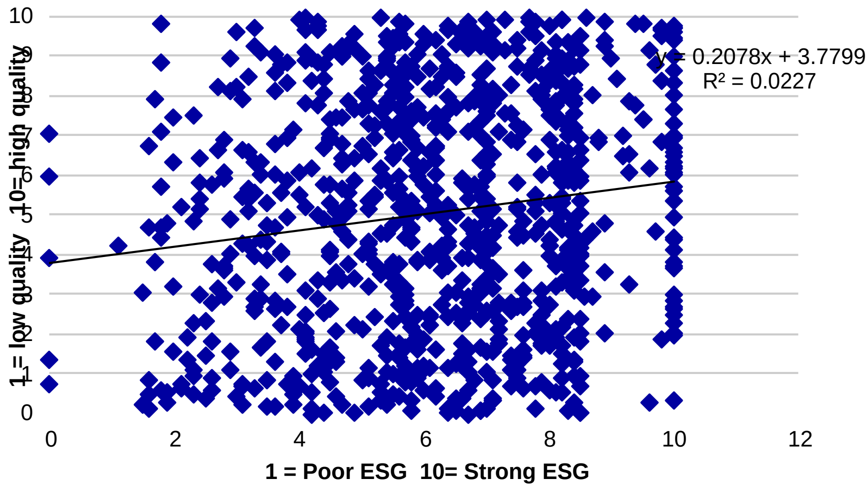


Source: MSCI, FactSet, Nordea

A combination of good returns, low gearing, high stability and low share price volatility paves the way

This stems from the fact that high ESG-rated corporates have higher operational returns and lower financial gearing. Furthermore, there is greater stability in their returns. This translates into share price volatility that is significantly lower for top ESG-rated stocks relative to low-rated stocks. However, before jumping to the conclusion that a high ESG score is equivalent to "high-quality stock", please review the scatter plot below. We find no correlation when testing the relationship between ESG ratings and the quality score. Against that backdrop, we argue that ESG is a standalone factor and that it offers complementary characteristics to both quality and value traits.

ESG AND QUALITY CORRELATION

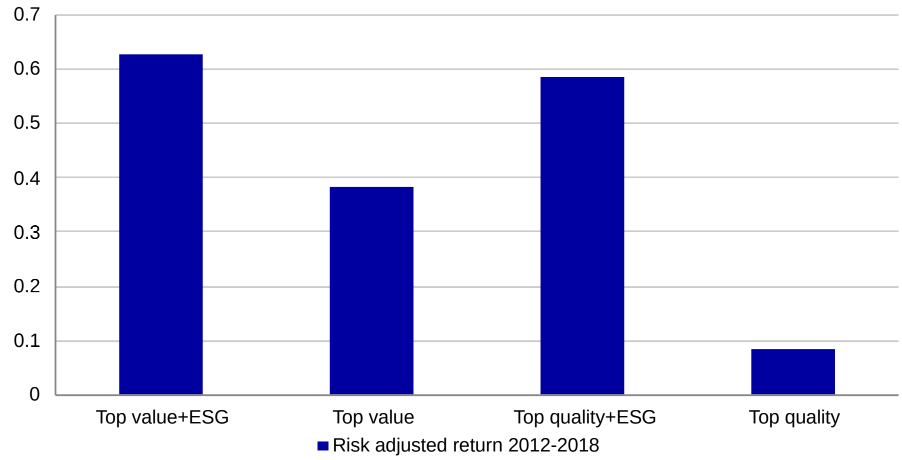


Source: MSCI, FactSet, Nordea

ESG has no correlation with other quality factors; it is an add-on that improves the risk-adjusted return

When adding ESG as a factor to value and quality over the past seven years, the risk-adjusted return improves. This is especially true when the ESG factor is added to quality. In addition to the growing willingness among investors to accept a premium for sustainable investment products, a steadily growing interest in sustainability and an increasing supply of ESG-focused mutual funds and other investment vehicles, we need to take account of a proposed new EU regulation that would require asset managers to add ESG labels and rank their portfolios accordingly. This proposal could become law in 2019. This could enhance the improved risk/reward for high ESG-rated assets even further. We therefore argue that adding the ESG factor to the search for a more defensive allocation would be wise.

RISK-ADJUSTED RETURNS, 2012-18



Source: MSCI, FactSet, Nordea

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Nordea Bank Abp

Nordea Markets Division, Research

Visiting address:
Aleksis Kiven katu 7, Helsinki
FI-00020 Nordea
Finland

Tel: +358 9 1651
Fax: +358 9 165 59710

Reg. no.: 2858394-9
Satamaradankatu 5
Helsinki

Nordea Bank Abp, filial i Sverige

Nordea Markets Division, Research

Visiting address:
Smålandsgatan 17
SE-105 71 Stockholm
Sweden

Tel: +46 8 614 7000
Fax: +46 8 534 911 60

Nordea Danmark, Filial af Nordea Bank Abp, Finland

Nordea Markets Division, Research

Visiting address:
Grønjordsvej 10
DK-2300 Copenhagen S
Denmark

Tel: +45 3333 3333
Fax: +45 3333 1520

Nordea Bank Abp, filial i Norge

Nordea Markets Division, Research

Visiting address:
Essendropsgate 7
N-0107 Oslo
Norway

Tel: +47 2248 5000
Fax: +47 2256 8650

Nordea