PICTET
Asset Management

ASSET ALLOCATION

Barometer: equities on the up

September 2017

Pictet Asset Management Strategy Unit

Stable global economic growth and ample central bank monetary stimulus are likely to boost risky assets again after a recent pullback

Table of contents

01 Asset allocation: conditions improve for riskier assets

02 Regions and sectors: trimming America

03 Fixed income: straining at the seams

04 Global markets overview: going for gold

05 In Brief

01

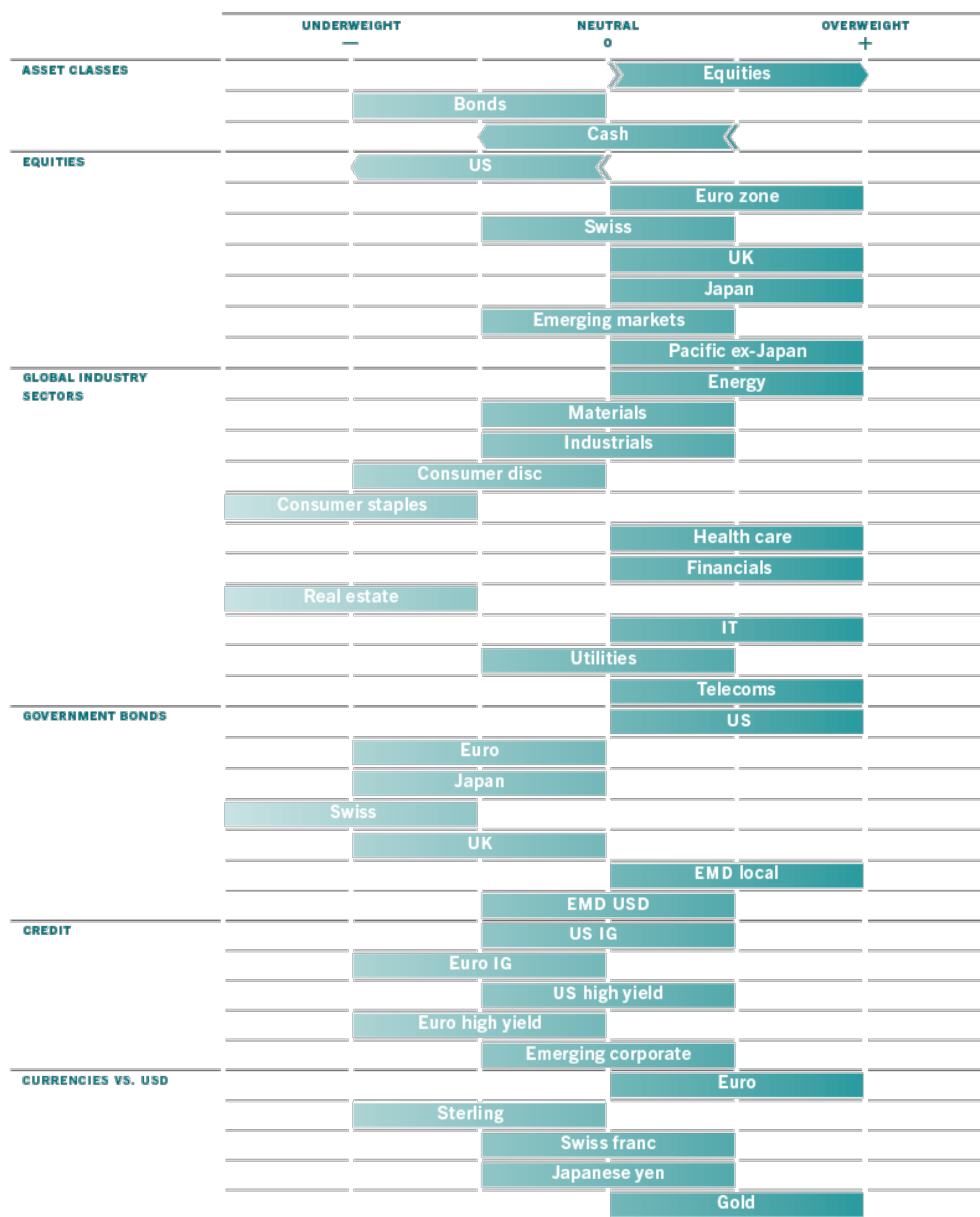
Asset allocation: conditions improve for riskier assets

It is a good time for investors to rebuild positions in riskier assets.

Despite some signs of weakness in recent months, the global economy continues to grow above what we consider to be its potential. What is more, policymakers do not appear to want to tighten the monetary reins just yet.

In fact, our analysis shows that monetary stimulus remains ample, with central banks printing around USD2 trillion of fresh money so far this year.[1] This, coupled with low inflation, is keeping real interest rates in many parts of the world below zero. The recent market correction has also taken stocks' valuations to a more attractive level, which leaves room for equities to rise into the final months of 2017. That's especially the case for stocks in Europe and some parts of Asia.

Against this backdrop, we have upgraded equities to overweight and downgraded cash to neutral. Our underweight stance in bonds is unchanged as we believe the asset class should remain under pressure at a time when economic growth is solid, inflation is unlikely to fall further and expectations for interest rate rises are low.



Pictet Asset Management

Our **business cycle** indicators show world economic growth is resilient. While our global leading indicators peaked in the first quarter, they have remained remarkably stable since, hovering at levels last seen in January 2014.

Preliminary Purchasing Managers' Index (PMI) data from the US and euro zone suggests manufacturing activity is gathering pace in those regions once again. At the same time, the Economic Surprise Index, a widely-followed indicator of whether economic growth is living up to consensus expectations, has resumed its climb (see chart). We see nothing in the medium term to derail economic growth; by our reckoning, the global economy is on track to grow 3.2 per cent this year, up from 2.7 per cent in 2016 and above its long-term potential of about 2.8 per cent. Only a few countries, such as the UK, Brazil and South Africa, are growing below their potential rate.

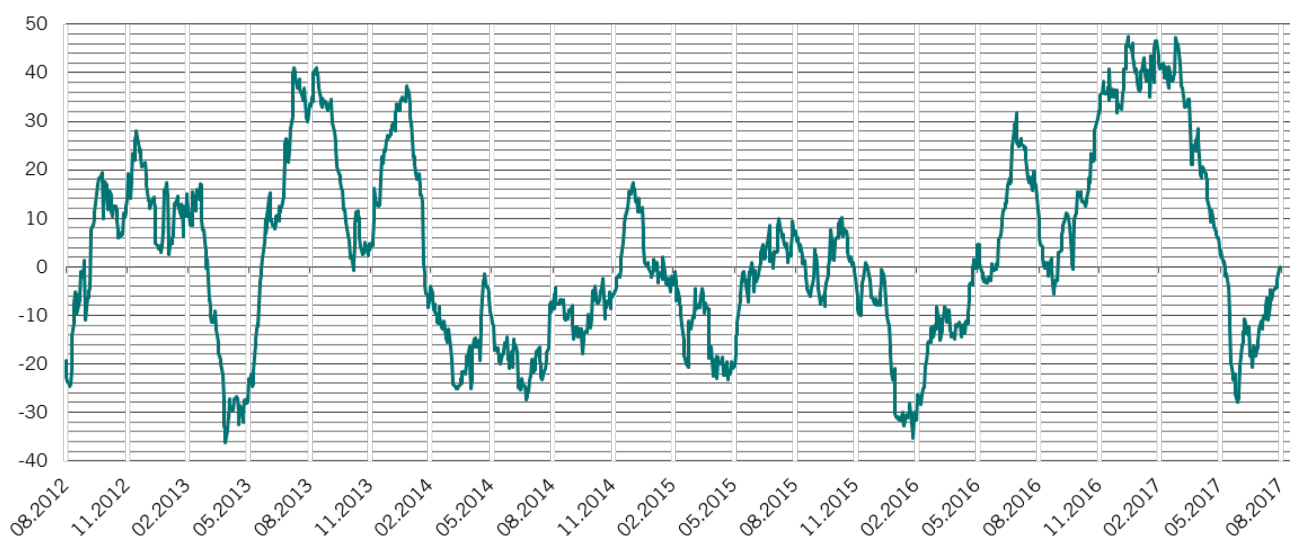
The euro zone is enjoying a stronger pace of economic growth in the second half of 2017, with retail sales and consumer confidence both rising above the long-term average. This, together with a stabilisation in core inflation, which is now above 1 per cent, should enable the European Central Bank to scale back its bond buying next year even though we believe an increase in its deposit rate is unlikely until the second half of 2018.

China's economic activity, meanwhile, is stable. Strong car sales data points to a pick-up in consumption, which is a key source of economic growth. Another positive is that debt reduction in the private sector is under way, with loans to non-bank financial institutions falling to 13.9 per cent of GDP, the lowest level since late 2013. More broadly in emerging markets, robust labour market conditions and stabilising currencies have helped drive consumer confidence to its highest level since November 1993. At the same time, inflation has hit a record low of 3 per cent, which should allow many emerging market central banks to maintain or even lower the cost of borrowing.

The picture is less rosy in the US; there our leading indicator dropped below the three-year moving average, having slowed for the fifth month in a row. Core inflation fell to 1.4 per cent in July but we expect this rate to gradually recover towards 2 per cent, thanks to strong labour market conditions and a weaker dollar. We continue to expect the US Federal Reserve to begin reducing the size of its balance sheet this year; its ability to deliver an interest rate hike in December, however, will depend on how quickly inflationary pressures pick up.

GLOBAL ECONOMIC GROWTH SURPASSING CONSENSUS FORECASTS

Citi Economic Surprise Index for G10



Thomson Reuters Datastream, Citigroup; data as of 29.08.2017

Our **liquidity** indicators suggest risks are balanced for riskier asset classes. The flow of central bank liquidity, measured by central bank net debt purchases as a percentage of GDP, has remained within a narrow 13-17 per cent range over the past six months.[2] This ample stimulus has served to offset a tightening of credit conditions in the private sector, especially in the US, where bank lending to businesses is contracting on a year-on-year basis – the first time this has happened outside recession since 1988.

The US and dollar-linked emerging economies are adding policy liquidity of as much as USD800 billion this year partly as emerging central banks rebuild foreign currency reserves, a factor which we think has contributed to recent dollar weakness.

Valuations for equities have improved following the market's recent correction. World stocks are trading just over 15 times next year's earnings – which is within the historical range. Moreover, equities offer a dividend yield of 2.5 per cent, nearly double the yield of global government bonds.[3]

That said, valuations differ by region and industry. US equities are particularly unattractive, trading at a cyclically-adjusted price-to-earnings (PE) ratio of 30, the highest since 1999, while stock market capitalisation to GDP ratio – Warren Buffet's favourite measure – stands at 1.33, near the peak reached in 2000. Consumer staples and industrials are the most expensive sectors, while telecoms and energy are the cheapest. In fixed income, European high yield bonds remain unattractive, whose yield has hit a record low of 3.1 per cent in recent weeks.

Technical signals remain positive for most equity regions and sectors. However, equities' implied volatility is low. Another red flag is that the recent rally in equities has been led by a narrow band of stocks, suggesting the market remains vulnerable to bad news.

[1] Central bank liquidity injection is calculated as volume of bond purchases and credit operations minus sterilisation
[2] Policy liquidity flow calculated as central bank net injection over preceding 6 months, as % of nominal GDP, using current-USD GDP weights (US 38.5%, China 23.6%, EMU 23.4%, Japan 9.5%, UK 5.0%)
[3] JP Morgan GBI

02

Regions and sectors: trimming America

Although some macroeconomic indicators have deteriorated somewhat during the past few months, growth across much of the developed world has remained above potential and inflation is well-behaved, the sort of Goldilocks environment that tends to be favourable for equities.

The European and Chinese economies are particularly robust. Factor in adequate liquidity conditions – in Asia they're actually improving – and the outlook is positive for risky assets, particularly equities. At the same time, earnings have been strong, making valuations look less stretched than they have been in the recent past.

Within the equities universe, we think that US shares have the most limited potential. The US is the most expensive equity region on a relative basis (see chart), trading, for instance, on a Shiller price-earnings ratio of more than 30, although it is marginally less expensive than it was a month ago. That's one reason US shares have struggled to gain ground despite a very strongly positive earnings season that saw 78 per cent of companies beating estimates and earnings per share growing 11 per cent on the year.

At the same time, the outlook for the US economy is also more uncertain than for other regions. The US leading indicator's momentum is deteriorating and bank lending data is worrying. This suggests that the Fed could be forced to moderate the planned reduction in the size of its balance sheet and put a halt to any further rate hikes this year, for fear of making a serious policy mistake.

US EQUITIES UNATTRACTIVE

US equities price to book ratio, relative to global stocks

Thomson Reuters Datastream, as of 29.08.2017

We remain positive on euro zone equities as they continue to benefit from the region's above-trend economic growth, which has been largely driven by accelerating household consumption. Leading indicators are turning increasingly positive in France, Germany and Spain. Consensus expectations for long-term corporate earnings growth are surging for Europe and for emerging market economies outside of Latin America.

We have also kept a single overweight on the UK, which should continue to benefit from a weaker sterling, notwithstanding some signs of economic softness. And we are positive on Asian shares. We've kept a single positive on both Japanese and Pacific ex-Japan equities. Japan has the best combination of relatively attractive valuations with strong growth momentum — in the second quarter, GDP grew by 4 per cent, which according to our models puts Japanese shares at a 10 per cent discount relative to world stocks. The caveat here is that North Korean belligerence has been increasing regional political risk.

While emerging market equities are likely to benefit from the weakness of the dollar, there are signs that the pace of gains may slow. Last month, for instance, there were more downgrades than upgrades of consensus estimates for emerging market corporate profits.

03

Fixed income: straining at the seams

Either leading economic indicators are too optimistic or bond markets are too bearish. A divide has opened in recent months between the bullish future painted by manufacturing and services surveys and the economically bleaker one the fixed income market is discounting (see chart). Ultimately that gap is bound to close, and we think that bonds are going to take the hit.

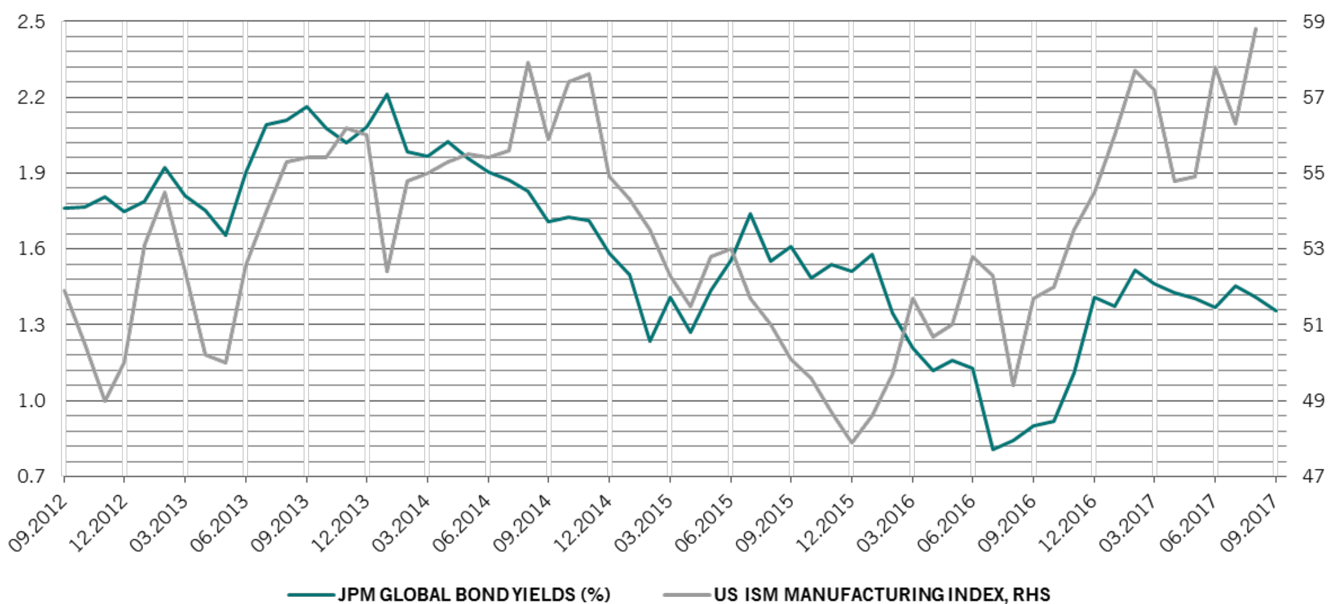
Ten-year German government bonds are yielding just 0.36 per cent, even though the country's inflation rate jumped to 1.8 per cent on a year-on-year basis in August from 1.5 per cent a month earlier. At the same time, Japan's 10-year government bonds are yielding a mere 0.01 per cent notwithstanding that the economy grew 4.0 per cent in the second quarter.

Yet, somewhat counter-intuitively, if bond markets do end up suffering, US Treasuries are still likely to be better placed than other developed world government debt.

For these reasons, we remain underweight government debt right across the developed world, with the exception of the US. Conversely, sovereign bonds in the emerging world look appealing.

AN OPENING DIVIDE

Global bond yields and ISM manufacturing index



Thomson Reuters Datastream, as of 08.29.2017

We remain positive on emerging market local debt, which has benefited from dollar weakness and broadly positive macroeconomic factors. A significant fall in inflation across almost all emerging economies – inflation in has dropped to a historic low of 3.0 per cent – has also increased expectations of interest rate cuts. One red flag, however, is that portfolio inflows into the asset class have started to moderate.

In light of particularly rich European bond valuations and expectations that the ECB will probably announce a tapering of its asset purchase programme in the not too distant future, we've maintained our underweight on European investment grade and high yield bonds. It's worth bearing in mind that yields on European high-yield bonds are below European dividend yields.

Meanwhile, trouble could be brewing in the credit market. Corporate debt issuance has been hefty, with investment grade US dollar denominated debt supply coming in at a record pace, running at USD984 billion by mid-August against USD937 billion in the same period last year.

Euro-denominated investment-grade bond issuance is also strong. Such large volumes of new paper could prove difficult for the market to absorb, not least because our sentiment gauges suggest investor positioning in most corporate credit asset classes is excessively bullish.

Another possible source of worry is that companies have become among the biggest buyers of corporate credit as they hunt out ways of generating a return from their growing cash piles. Bank of America estimates that two dozen of the US's biggest non-financial companies now hold USD376 billion of corporate bonds. The risk is that this demand isn't stable and the market is becoming a house of cards.

Among currencies, we have kept our overweight on the euro, which notwithstanding its recent strength could have a way to run as euro zone economic recovery gains strength and the ECB looks to start unwinding its extremely accommodative policy. Gold also remains an overweight, which, among other things, is being supported by strong demand trends and seasonal factors.

04

Global markets overview: going for gold

Gold was the star performer in August, climbing by more than 3 per cent to hit 9-1/2 month highs. The metal's safe haven status came into play after a North Korean missile passed over northern Japan, exacerbating geopolitical tensions in the region.

Thomson Reuters Datastream, as of 29.08.2017

Bond markets also did well thanks to the scaling back of expectations for monetary tightening in the world's major economies. In the US, news that annual inflation is running at its slowest pace since late 2015 coupled with data showing slightly weaker economic activity bolstered the case for the Fed to refrain from further interest rate hikes this year. (Ten-year US bond yields fell below 2.10 per cent during the month, the lowest level since mid-November 2016.) Similar forces have been at play in the UK, while in the euro zone the key restraining force on monetary policy has come not from the economy but from currency appreciation.

The euro added 0.8 per cent versus the dollar in the past month. The Russian rouble, the South African rand and the Turkish lira also climbed higher. Together, their gains helped push the greenback to a 2-1/2 year low versus a trade-weighted basket of currencies in August (see chart). However, the dollar's retreat paled into insignificance when compared with the rout in sterling. The UK unit slumped to an eight year low versus the euro – approaching parity levels – and lost 2.3 per cent versus the US dollar.

Elsewhere, a broadly stable showing for global equities masked stark divergences between countries and sectors. Emerging markets did particularly well, welcoming the scaling back of Fed rate hike expectations as well as strong manufacturing data from China. US and euro zone shares were broadly flat, while unfavourable exchange rate effects pushed the dollar returns from UK shares firmly into the red.

Among sectors, telecoms and materials fared the best, while energy underperformed as an expected recovery in oil prices failed to materialise.

05

In Brief

SEPTEMBER 2017

Asset allocation

We raise equities to overweight and downgrade cash to neutral, against the backdrop of resilient economic growth and ample central bank monetary stimulus.

Regions and sectors

We cut US equities to underweight as the US is seen underperforming other markets following a period of relative outperformance.

Fixed income

Expensive valuations keep us cautious about bond and credit markets, though we remain relatively overweight US Treasury bonds as a hedge against any sudden flight from risk.

Important legal information

This marketing document is issued by Pictet Asset Management. It is neither directed to, nor intended for distribution or use by any person or entity who is a citizen or resident of, or domiciled or located in, any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation. Only the latest version of the fund's prospectus, the KIID (Key Investor Information Document), regulations, annual and semi-annual reports may be relied upon as the basis for investment decisions. These documents are available on **assetmanagement.pictet**.

This document is used for informational purposes only and does not constitute, on Pictet Asset Management part, an offer to buy or sell solicitation or investment advice. It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. The effective evolution of the economic variables and values of the financial markets could be significantly different from the indications communicated in this document.

Information, opinions and estimates contained in this document reflect a judgment at the original date of publication and are subject to change without notice. Pictet Asset Management has not taken any steps to ensure that the securities referred to in this document are suitable for any particular investor and this document is not to be relied upon in substitution for the exercise of independent judgment. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Before making any investment decision, investors are recommended to ascertain if this investment is suitable for them in light of their financial knowledge and experience, investment goals and financial situation, or to obtain specific advice from an industry professional.

The value and income of any of the securities or financial instruments mentioned in this document may fall as

well as rise and, as a consequence, investors may receive back less than originally invested. Risk factors are listed in the fund's prospectus and are not intended to be reproduced in full in this document.

Past performance is not a guarantee or a reliable indicator of future performance. Performance data does not include the commissions and fees charged at the time of subscribing for or redeeming shares. This marketing material is not intended to be a substitute for the fund's full documentation or for any information which investors should obtain from their financial intermediaries acting in relation to their investment in the fund or funds mentioned in this document.

EU countries: the relevant entity is Pictet Asset Management (Europe) S.A., 15, avenue J. F. Kennedy, L-1855 Luxembourg
Switzerland: the relevant entity is Pictet Asset Management SA , 60 Route des Acacias – 1211 Geneva 73