PICTET
Asset Management

ASSET ALLOCATION

Stocks will keep on giving

Barometer

October 2017

Pictet Asset Management Strategy Unit

Equities and other risky assets set to extend their rally as world economy gathers steam.

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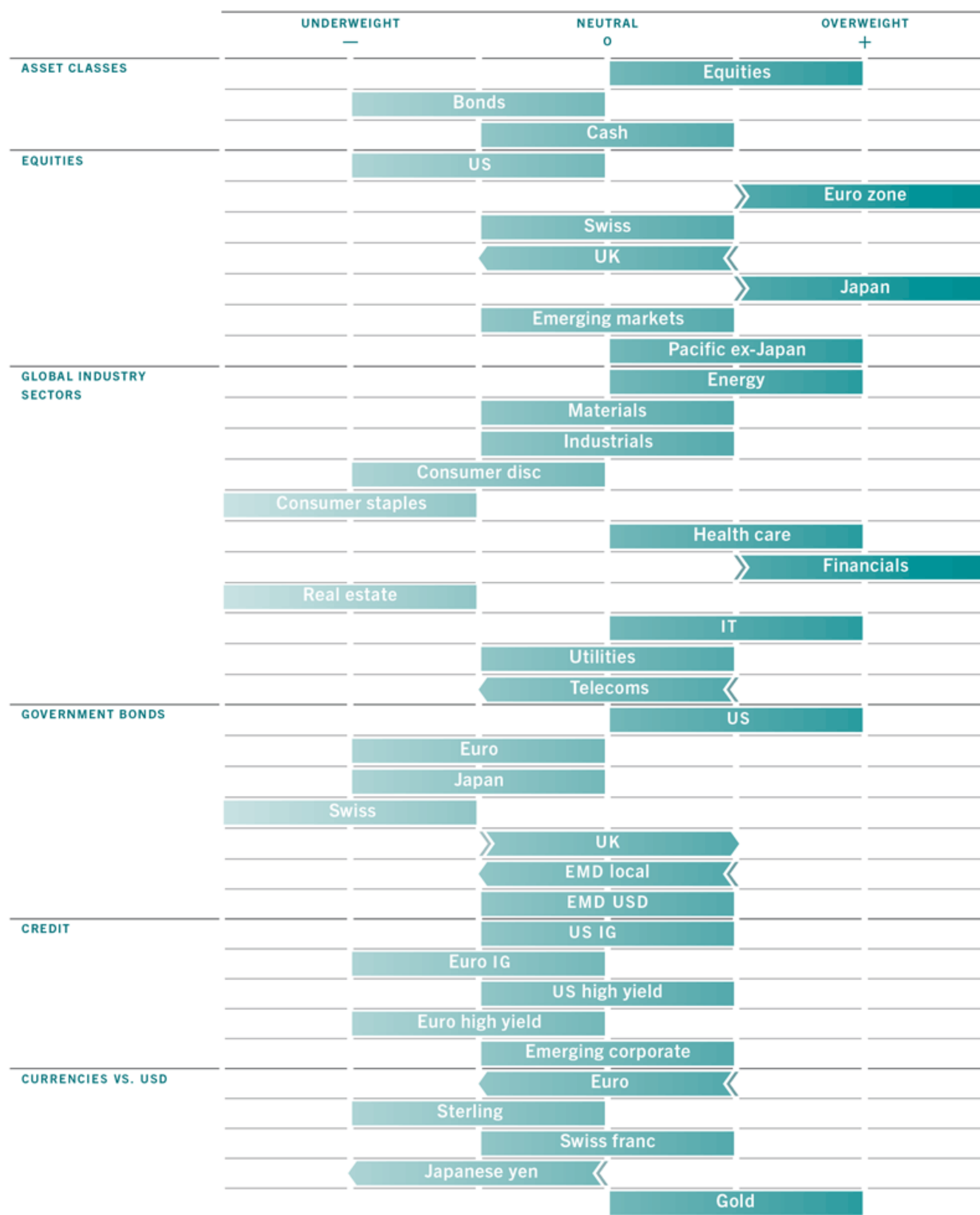
Asset allocation: harmonised growth should support equities

The bull market in stocks may be testing historical boundaries but there is plenty to suggest the rally should continue. We are consequently keeping our overweight in stocks and our underweight in bonds.

Economic activity is gathering pace again, both in developed and emerging countries. And even though central banks are starting to withdraw their stimulus, global monetary conditions remain favourable, not least because low inflationary pressures could allow authorities to normalise policy at a gentle pace. What is more, not only are corporate earnings extending a broad-based and synchronised recovery, but our valuation gauges indicate that most risky assets have yet to reach the excessively expensive levels usually seen towards the end of the business cycle.

Against this backdrop, we are overweight euro zone and Japan equities, which are best positioned to build on recent gains. Our underweight position in bonds remains unchanged as we think accelerating growth will put downward pressure on fixed income assets.



Source: Pictet Asset Management

Our **business cycle** analysis shows the world economy is maintaining strong momentum. The most recent leading indicators ticked up year on year, while our analysis of purchasing managers' data shows global manufacturing activity accelerated to its highest level since early 2011. We believe the global economy is on track to grow at an annual rate of 3.4 per cent this year, the fastest since 2010.

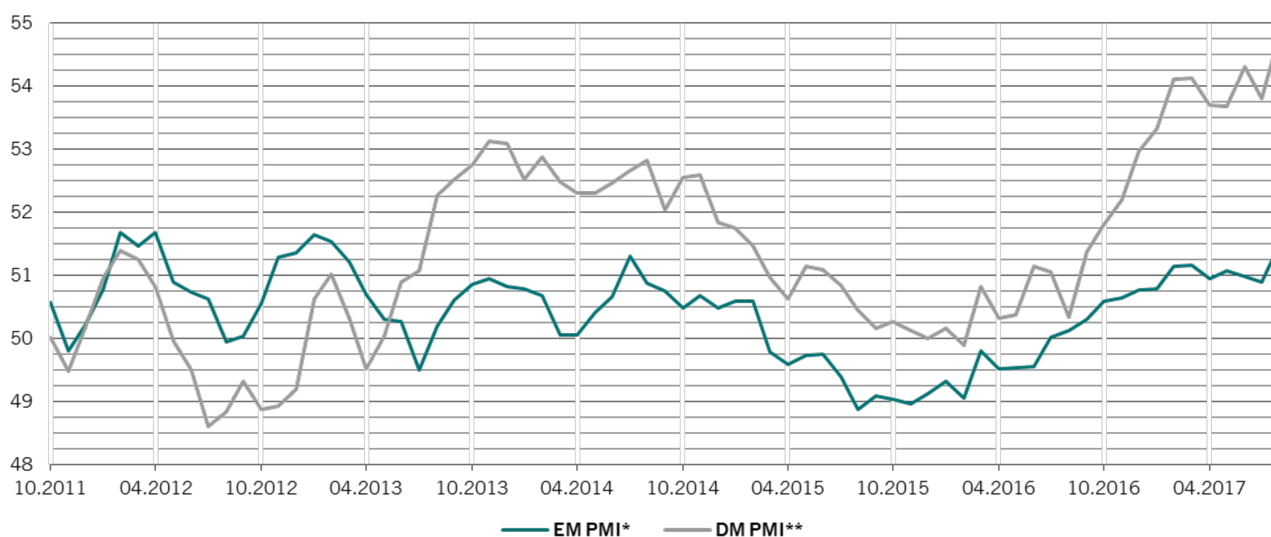
In the US, strong labour market conditions and low household debt are supporting consumer spending. The effects of hurricanes Harvey and Irma may shave around 0.5 percentage points off third-quarter GDP, but housing and construction spending should offset that. Inflation is contained for now, with core consumer price index (CPI) growth staying well below the February peak of 2.3 per cent. However, investors may be too complacent when it comes to inflation, especially as economic activity and employment remain buoyant. The New York Federal Reserve has warned that its underlying inflation gauge, which includes macroeconomic and financial variables, hit a 10-year high in August. We expect core inflation to rise towards to 2 per cent next year; any unexpected strength in inflation could prompt the Fed to raise interest rates more aggressively, beyond a widely-anticipated hike this December.

The euro zone's economic recovery is gaining strength, thanks to rising retail sales, improving labour market conditions and upbeat consumer sentiment, as well as higher business investment. This, we believe, makes it likely that the European Central Bank will announce a curtailing of its bond purchase plan in October.

China's economic growth remains stable while other emerging economies continue to see strong retail sales. Consumer sentiment across the developing world hit its highest level since 1993, our calculations show. Headline inflation fell to 3 per cent on the year on a three-month moving average basis, the lowest since data began in 1970, partly as a result of falling commodity prices. Weak price pressures should allow emerging central banks to maintain, or even cut interest rates to boost the economy.

SYNCHRONISED GROWTH

Purchasing manager indicies: developed markets (DM) and emerging markets (EM)



Source: Pictet Asset Management, Thomson Reuters Datastream, as at 27.09.2017

*GDP-weighted manufacturing PMI data covering 24 emerging markets; **GDP-weighted manufacturing PMI data covering 34 developed markets

Liquidity conditions are neutral for riskier asset classes. Despite rate hikes in the US earlier this year, central banks worldwide are still providing ample monetary stimulus. The total flow of central bank and private sector liquidity remains in the middle of a 13-17 per cent range of the past two years for major countries.[1] Private credit growth is sluggish everywhere except China. US bank lending is unusually weak at this stage in the business cycle, which means the Fed's plan to reduce the size of its balance sheet could have a negative impact on the economy unless the US administration reaches a deal on easing banking sector regulations, a move that could help boost borrowing among both households and companies.

Our **valuation** metrics suggest equities are fairly priced but bonds remain expensive. Corporate earnings – the changes in which have been responsible for a third of the moves in the S and P 500 index over the past two decades, according to our analysis – are growing at double-digit rates worldwide for the first time since 2012. There are, however, certain sectors and regions where our models suggest taking a cautious stance. US equities are among them, as key indicators of valuation, such as the cyclically-adjusted price-to-earnings (PE) ratio or stock market capitalisation to GDP ratio, hover at levels not seen since 1999.

Our **technical** indicators support a bullish stance on equities in most sectors and regions, except for the UK. The Bank of America Merrill Lynch survey shows investors hold an above-average 4.8 per cent of their portfolios in cash, which suggests more money could flow into stocks in the coming months. Separately, our technical gauges suggest that the dollar is due a bounce back.

[1] Total flow of central bank liquidity, measured by volume of bond purchases and credit operations minus sterilisation, 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%) Private liquidity flow calculated as bank and non-bank credit flow over preceding 6 months, as % of nominal GDP, using current-USD GDP weights (US: 38.2%, China: 23.1%, EMU: 24.1%, Japan: 9.5%, UK: 5.1%)

02

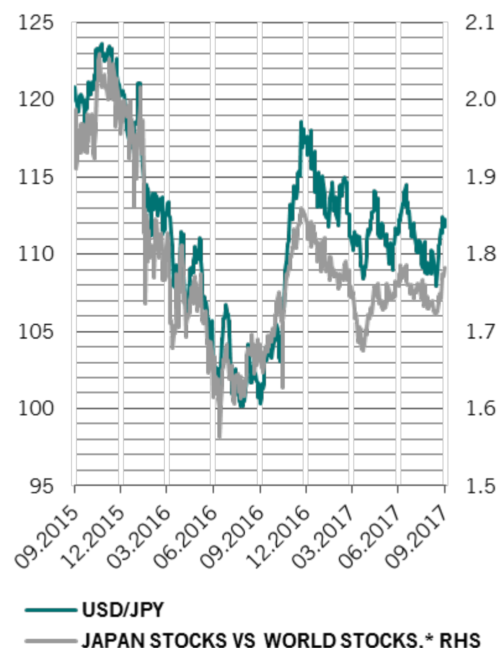
Equities and regions: flashing green for Europe and Japan

For global equities, weather conditions are good. Not only do stocks benefit from positive seasonal trends – markets tend to do well in the final months of the year – but this time fundamentals are also flashing green. Corporate profits were strong in the second quarter and are on track to be even better in the third thanks to solid economic growth and well-behaved inflation. Profit margins and revenues are on the rise in many regions.

Regionally, we see the most attractive prospects in the euro zone and Japan, and are increasing our exposure to both. The former is enjoying some of the best economic momentum within the developed world. Euro zone economic confidence surged to a 10-year high in September, consistent with annualised GDP growth of some 3 per cent. Japan, meanwhile, is one of the cheapest equity markets according to our models.

Both markets should benefit from a likely bounce back in the US dollar, which makes European and Japanese goods more competitive and boosts the value of exporters' foreign earnings. Sentiment also plays a part, with investors in Japanese stocks tending to be particularly sensitive to shifts in the yen/dollar exchange rate. Historically, Japanese equities' relative performance has shown more sensitivity to currency fluctuations than any other major market: a 10 per cent appreciation of the dollar versus the yen typically leads to a 20 per cent outperformance of Japanese stocks in local currency terms (see chart).

JAPAN STOCKS COULD GET BOOST FROM DOLLAR BOUNCE



Source: Thomson Reuters Datastream, as of 27.09.2017 *MSCI Japan performance relative to MSCI ACWI in local currency terms

For investors with a diversified portfolio, therefore, an allocation to these markets can act as a hedge against dollar strength.

Elsewhere, we are neutral on Swiss and UK stocks. UK equities have suffered due to the market's greater exposure to defensive stocks and from the recent appreciation of sterling.

While we remain encouraged by the long-term potential of EM assets, the market's 20-plus per cent gain so far this year and a likely rebound in the value of the dollar prevents us from adding to our exposure at this juncture.

The US is our least favoured equity region. Already the most expensive of all the markets we analyse, its valuations have stretched even further in the past month. The S and P 500 is trading on a cyclically-adjusted price/earnings ratio of over 30 times, while US stocks' market capitalisation to GDP ratio is nearing its 2000 peak. Even after taking into account the fact that the US market has a more growth-oriented sector composition – the top five companies in the world are US techs with a market cap in excess of USD3 trillion – US equities are some 20 per cent more expensive than global stocks.

One saving grace for the US market could be its relatively hefty share of financial stocks – the third biggest sector in the S and P 500 – which are becoming an increasingly attractive investment opportunity. Firstly, Fed rate hikes should help improve the profitability for banks. Secondly, the industry should also benefit from Trump administration's push for financial deregulation. At the very least, regulation is unlikely to be tightened further under the current US president. For these reasons, we have raised our exposure to financial stocks.

Another cheap, economically-sensitive sector we favour is energy. Not only are oil prices close to a two-year high, energy stocks are also under-owned and offer a close to 4 per cent dividend yield. We also continue to see opportunities in healthcare and technology, but have turned more cautious on telecoms. Although the telecom sector is by far the cheapest sector according to our analysis, we think it is in danger of becoming a value trap. The industry's intensifying price competition – particularly in the US – is taking its toll on margins and cashflow, potentially putting dividends at risk.

03

Fixed income: the dollar looks up

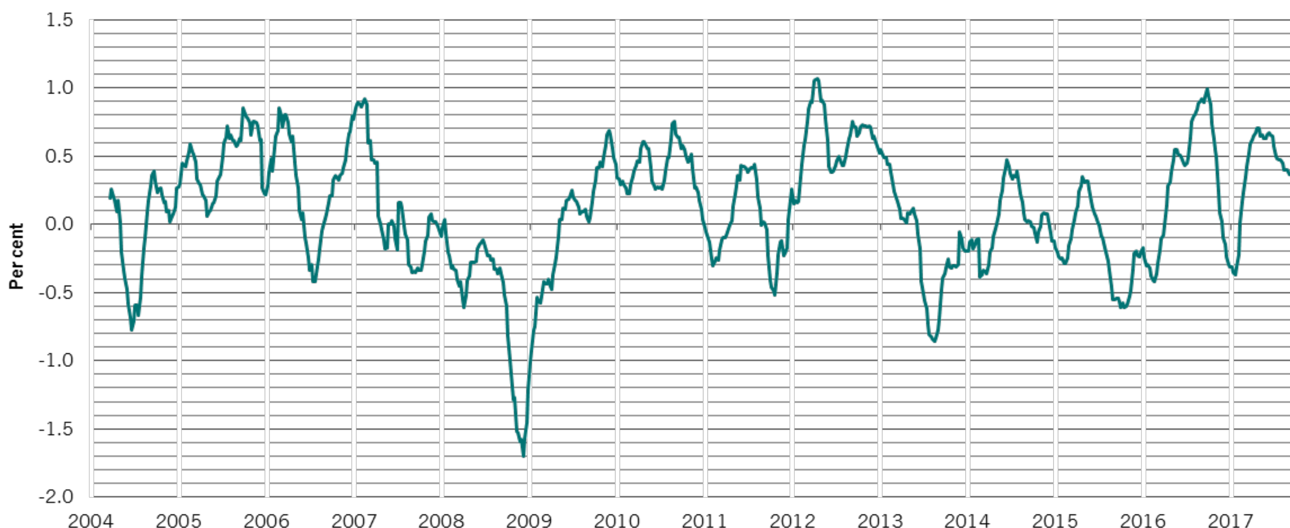
Now seems a good time to take profits on emerging market (EM) local currency bonds, which is why we've cut our position on the asset class from overweight to neutral.

Not only has EM local debt had a particularly strong run amid strong flows (see chart) – the benchmark JPMorgan GBI-EM local currency bond index is up 9.1 per in dollar terms since the start of the year – but the asset class faces growing risks, not least from the prospect of a strengthening dollar.

The dollar has suffered this year from disappointment at President Trump's political travails, as he's struggled to enact a legislative programme and has been a divisive figure not only nationally but also within his own Republican Party. But there are signs that sentiment has swung too far – for example, prospects have improved for an overhaul of corporate and individual tax in the US , a deal that could be agreed by the first quarter of 2018.

At the same time, the risks of a Fed rate hike in December are rising – the market is currently pricing in a 70 per cent chance of a move – despite the fact that the central bank will also start shrinking its balance sheet from October. Fed Chair Janet Yellen's thinking remains framed on the Philips Curve, which is to say she still thinks that a tightening US labour market will eventually feed through to inflation. Sentiment indicators on the dollar are also flashing oversold, which could pave the way for a rally. The dollar's gain would come at the expense of emerging currencies, which would weigh heavily on the return of local currency EM fixed income assets.

FLOWS INTO EMERGING MARKET BONDS HAVE BEEN STRONG
Flows as % of total net assets , 12-week moving average



Source: EPFR as of 27.09.2017

The only class of bonds that we remain positive on is US Treasuries, which we have kept at overweight, largely because it continues to be a hedge against any sudden risk off move by the market. Another corollary of dollar strength is weaker dollar crosses, including the euro, which we've cut from overweight to neutral.

The euro has had a good run against the dollar, up some 12 per cent year to date, amid a strengthening euro zone economy. But we think the currency is now over-egging the difference in both economic momentum between the euro zone and the US and in the future direction of monetary policy. What's more, German Chancellor Angela Merkel's weakened political position following recent elections is likely to muddy the waters for European reforms, which also contributes to weaker euro sentiment. We have also cut the Japanese yen from overweight to neutral.

Separately, we remain underweight sterling. The pound has picked up recently on increasingly hawkish noises coming from the Bank of England. But we think expectations of BoE tightening are overdone in light of the economy's Brexit-related vulnerabilities. It's unlikely to be nearly as aggressive on inflation as investors have come to believe. By the same token, we think the recent sell-off in UK government bonds has gone too far. Ten-year gilt yields have risen more than 30 basis points to 1.38 per cent during September, which is why we've upgraded them to neutral from a single negative.

04

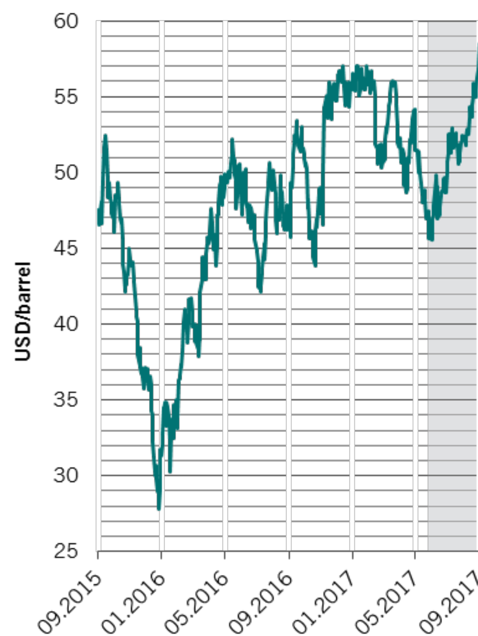
Global markets review: equities, oil firmer

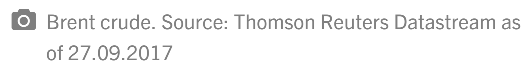
Equities outperformed bonds in September as robust economic data reinforced the view that global growth would remain strong.[2] Energy was the best performing equity sector over the month as supply restrictions boosted oil by 8 per cent on the month (see chart). Financial stocks rose more than 3 per cent as expectations of tighter monetary policy and a possible easing of bank sector regulations in the US augured well for a pick-up in the industry's profits.

European stocks gained nearly 4 per cent, becoming the best performing region as the euro zone economy enjoyed strong momentum, reinforced by upbeat consumer sentiment and higher business investment.

OIL MOVING HIGHER

Brent crude, dollars per barrel




Brent crude. Source: Thomson Reuters Datastream as of 27.09.2017

In fixed income markets, US Treasuries fell nearly 1 per cent, pressured by expectations for further Fed interest rate hikes and concerns over the US's fiscal position following the announcement of Donald Trump's as-yet unfunded proposal to cut taxes. The 10-year yield hit a two-month high of 2.36 per cent in September while the 30-year bond yield posted the biggest one-day jump in almost seven months.

EM bonds ended down in aggregate but held up better than developed world government debt as falling inflation boosted expectations EM central banks could lower interest rates to support growth.

In the currency markets, the dollar gained ground against most major currencies, including the euro, Japanese yen and Swiss franc.

Sterling bucked the trend, rising some 4 per cent on the month against the dollar and hitting a 12-month peak at one point as the BoE unexpectedly hinted at an interest rate hike by the end of the year.

[2] All returns expressed in local currency terms unless otherwise stated

05

In brief

OCTOBER 2017

Asset allocation

Equities are likely to extend the rally. We keep our overweight in stocks and underweight in bonds.

Equities and regions

The euro zone and Japan are regions where we see the most attractive prospects. We upgrade financials, while we cut telecoms to neutral.

Fixed income and currencies

It's time to take profits on emerging local currency debt. We downgrade the euro and yen as we believe the dollar is set for a rebound. We upgrade gilts after the recent sell-off.

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