PICTET
Asset Management

BAROMETER OF FINANCIAL MARKETS FEBRUARY OUTLOOK
February 2023

Marketing Material

Barometer: Economic clouds lift but risks linger

Economic conditions appear to be stabilising but with corporate earnings prospects lacklustre, equities don't look great value.

Table of contents

01 Asset allocation: better than feared?

It’s early days, but so far 2023 is shaping up better than predicted even a few weeks ago.

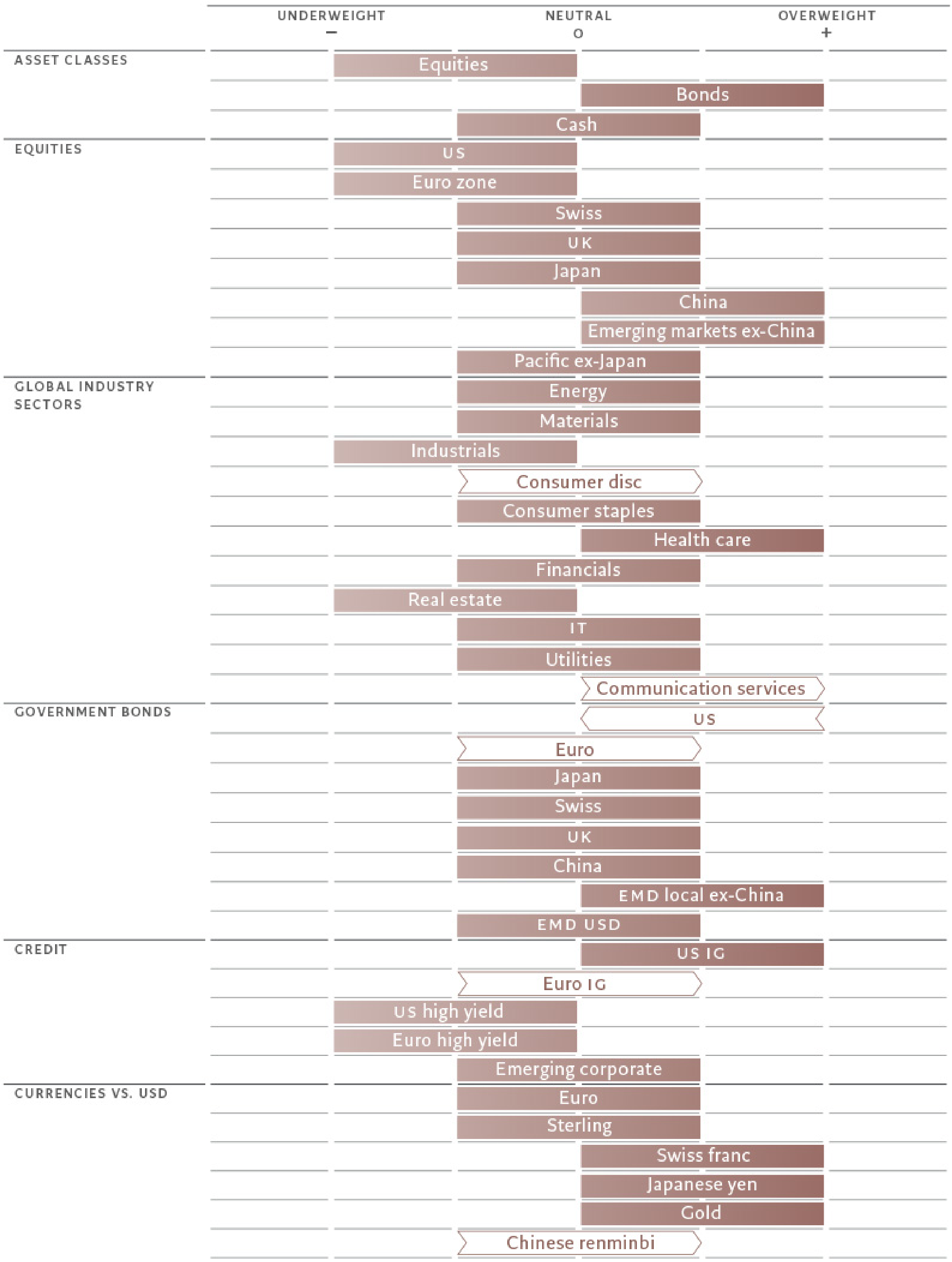
US inflation has clearly peaked, the European economy is proving more resilient than some had feared, energy price dynamics are benign and the re-opening of China’s economy has progressed at a pace that has exceeded even the most optimistic expectations.

Clouds are clearly starting to lift, but we believe it’s too soon to make a decisive move into equities – after all, valuations are not particularly cheap, corporate earnings are stagnant and global growth is tepid at best. Also, the all important US consumer is not out of the woods yet.

We therefore retain an overall underweight stance on equities and an overweight position in bonds, while tactically increasing exposure to sectors such as communication services.

Fig. 1 - Monthly asset allocation grid

February 2023



Source: Pictet Asset Management

Our **business cycle** indicators remain negative for the world economy as a whole, but the picture is less gloomy than it was a month ago. The outlook for China has turned positive, with the economy expected to benefit from an increase in consumption. As the country emerges from its Covid-induced lockdowns, there is some RMB5 trillion (USD740 billion) of excess household savings that can potentially be spent.

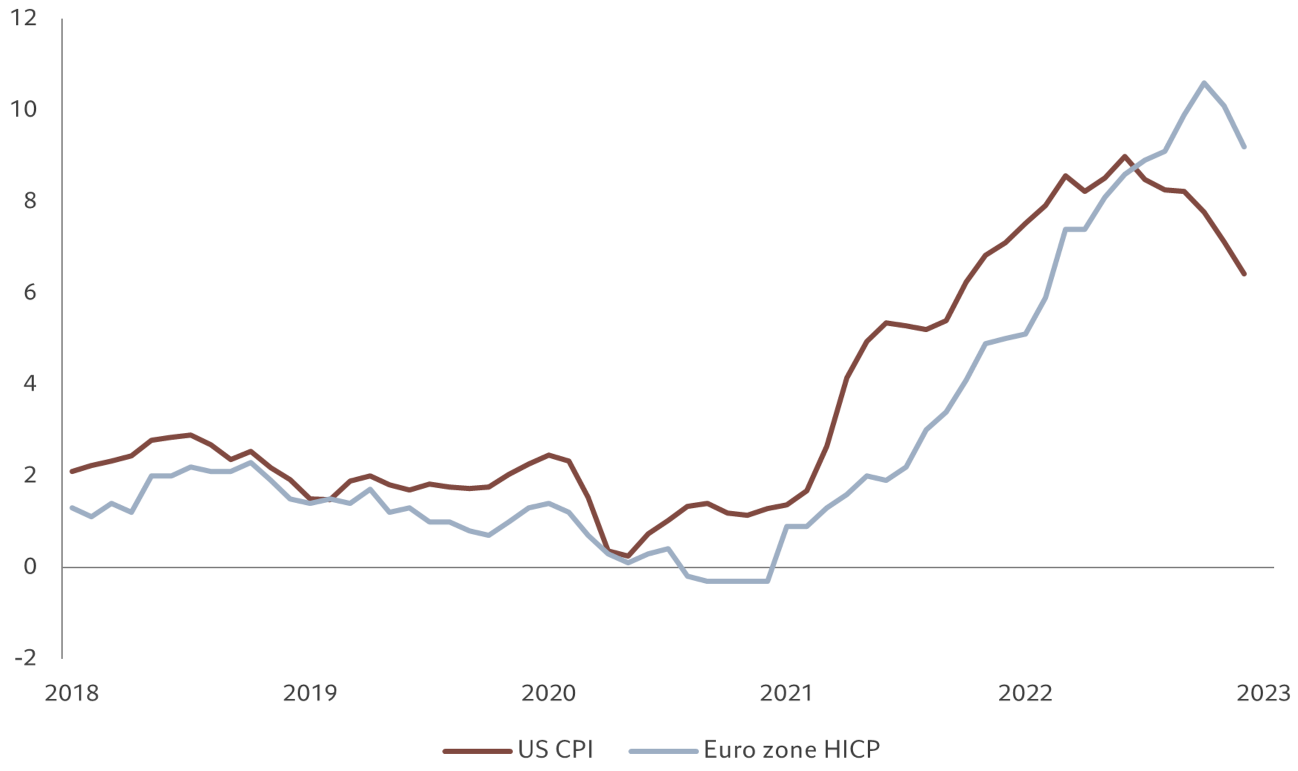
That will have wider repercussions through increased goods trade, a pick-up in Chinese tourism and higher demand for commodities, particularly base metals. The key beneficiaries from China's economic revival include Hong Kong, Singapore, Korea, Vietnam and Taiwan, as well as Japan and Australia.

Crucially, we don't expect China's resurgence to feed global inflationary pressures, as was the case when US and Europe re-opened. The key differences between China's re-opening and that of the developed world countries are that there were no fiscal transfers to Chinese consumers during the pandemic (in stark contrast to the cheques handed out in the US), global supply constraints have eased, the output gap in China is larger and the Chinese labour market shows no signs of wage pressure.

Our expectations for a worldwide moderation of price pressures have been reinforced by ever more proof that inflation in the US and Europe has peaked (see Fig. 2), which is good news for riskier assets. In Europe this has translated into a brighter economic outlook than previously expected, with the improving inflation dynamics boosting consumer confidence.

Fig. 2 - Past the peak

US and euro zone inflation (%, y/y)



Source: Refinitiv DataStream, Pictet Asset Management. Data covering period 01.01.2018-31.12.2022.

Our **liquidity** scores show Europe having the tightest credit conditions of any major region.

Conversely, mixed US data has nudged up the probability of a recession on the other side of the Atlantic, although this is still not our base case scenario. Our model suggests the US Federal Reserve's tightening is near completion, but easing is likely still a long way off due to fear of re-igniting inflation.

In the developing world, meanwhile, liquidity is ample, supporting our positive stance on emerging market assets.

Our **valuation** indicators flash green for emerging market equities too, with emerging Europe and Latin America looking particularly cheap.

More broadly, our valuation analysis suggests that any meaningful upside for equities will need to come from corporate earnings growth rather than an expansion in earnings multiples. Stocks' price/earnings ratios have already increased as inflation has ebbed; they consequently exhibit no more upside over the next 12 months according to our fair-value model.

Yet, the picture for corporate earnings is similarly uninspiring: we expect global profits to be flat this year, with growth in emerging markets offset by a decline in Europe.

In the US, there are early signs that analysts' downward earnings revisions are easing. However fourth quarter expectations are already very low, which means that companies that end up beating profit forecasts are unlikely to see analyst upgrades. Corporate guidance remains downbeat, with the pessimism shifting from margins to revenue. Until we see this situation improve, we are unlikely to raise our allocation to equities.

Technical indicators point to a rapid rebound in risk appetite. Weekly inflows into emerging market equity and bond funds hit a record high of USD13 billion, and there was also strong appetite for investment grade and high yield credit.

Implied volatility for equities fell to its lowest level in nearly a year, and demand surged for single stock call options. In contrast, sentiment on the dollar deteriorated.

02 Equities regions and sectors: China re-opening boost for emerging markets

China's reopening is shaping up to be this year's defining investment theme.

The speed and scale of China's emergence from lockdown has exceeded even the most optimistic of expectations, triggering a rally of 50 per cent in the country's equity market. This has seen China's forward price/earnings multiples rise to 12 late in January from a 2015 low around 8 hit in October.

The dizzying gains mean Chinese stocks are no longer cheap, yet we believe there's more upside.

The next phase in the market rally will be fuelled by robust growth in earnings of Chinese companies, which we believe could surpass the consensus forecast for 15 in the next 12 months.

Profits are poised to rise as the return to more normal economic conditions will unleash pent-up demand among Chinese consumers, who have excess savings of as much as 4 per cent of GDP.[1]

An improvement in consumer spending is poised to benefit consumer discretionary and property sectors in particular, which should also be supported by continued monetary stimulus from the People's Bank of China.

A pick-up in profit growth is long overdue. Investors in China have suffered a lost decade when it comes to earnings growth – profits generated by companies in the benchmark MSCI China index have been flat since late 2015, paling in comparison to the 85 per cent increase delivered by S&P 500 constituents.

The reopening of China's economy, therefore, could mark a reversal of that trend.

All of this should encourage global investors to increase their holdings of Chinese stocks closer to benchmark weights after remaining underweight since 2015.[2]

China's return to the global stage also improves the dynamics for emerging markets, which already enjoy a superior growth premium to their developed peers. Investors are greatly underestimating earnings growth of emerging market companies this year -- we expect their earnings to grow by high-single digits in 2023, compared with a consensus forecast for close to flat.

Elsewhere, we remain underweight US and European stocks as higher input costs and lacklustre economic growth will pressure profit margins and wipe out corporate earnings growth.

We expect European earnings to contract as much as 7 per cent this year, which sits in stark contrast to a consensus forecast for EPS growth of 1 per cent. We also expect US corporate earnings to contract.

We are also neutral Japanese stocks. While the return of inflation and an improvement in corporate and household spending bode well for the long-term earnings prospect of Japanese companies, weak global demand and a stronger yen may cap the upside in the near term.

Fig. 3 - Value shift

Communication services price to book vs US real rates

Source: Refinitiv, data covering period 01.01.2014 – 25.01.2023.

Separately, following last year's market rout, one which saw growth-orientated sectors bear the brunt of tightening monetary policy, we see a tactical opportunity to add companies exposed to secular growth. With central banks set to place rate hike campaigns on pause later in the year, pressure should come off stocks' earnings multiples, especially among those with a growth tilt.

Furthermore, US big tech stocks' earnings estimates – which reached unrealistically high levels during the pandemic -- have largely eased back to more reasonable levels.

We are also attracted to interactive media stocks, which offer superior growth potential. We therefore upgrade communication services to overweight from neutral.

What is more, this sector also has a more defensive subsector of telecoms, which should give protection if economic activity weakens further.

We upgrade consumer discretionary to neutral from underweight as consumer sentiment is showing early signs of improving as slowing inflation begins to take some pressure off consumers.

Companies exposed to a recovery in Chinese consumption and tourism, such as premium luxury goods firms, should continue to benefit. That said, we're yet to take this position to overweight. Concerns persist over the outlook of goods consumption in developed economies as spending is set to be more focussed on services and evidence is mounting of job cuts in sectors employing high-earners.

[1] Refinitiv, IBES, IMF forecast, Pictet Asset Management. *calendar year % change in EPS. Model based on domestic and global GDP growth (level and acceleration), in current USD.
[2] Based on long-only mutual funds positions, source: EPFR

03 Fixed income and currencies: euro zone bonds looking cheaper

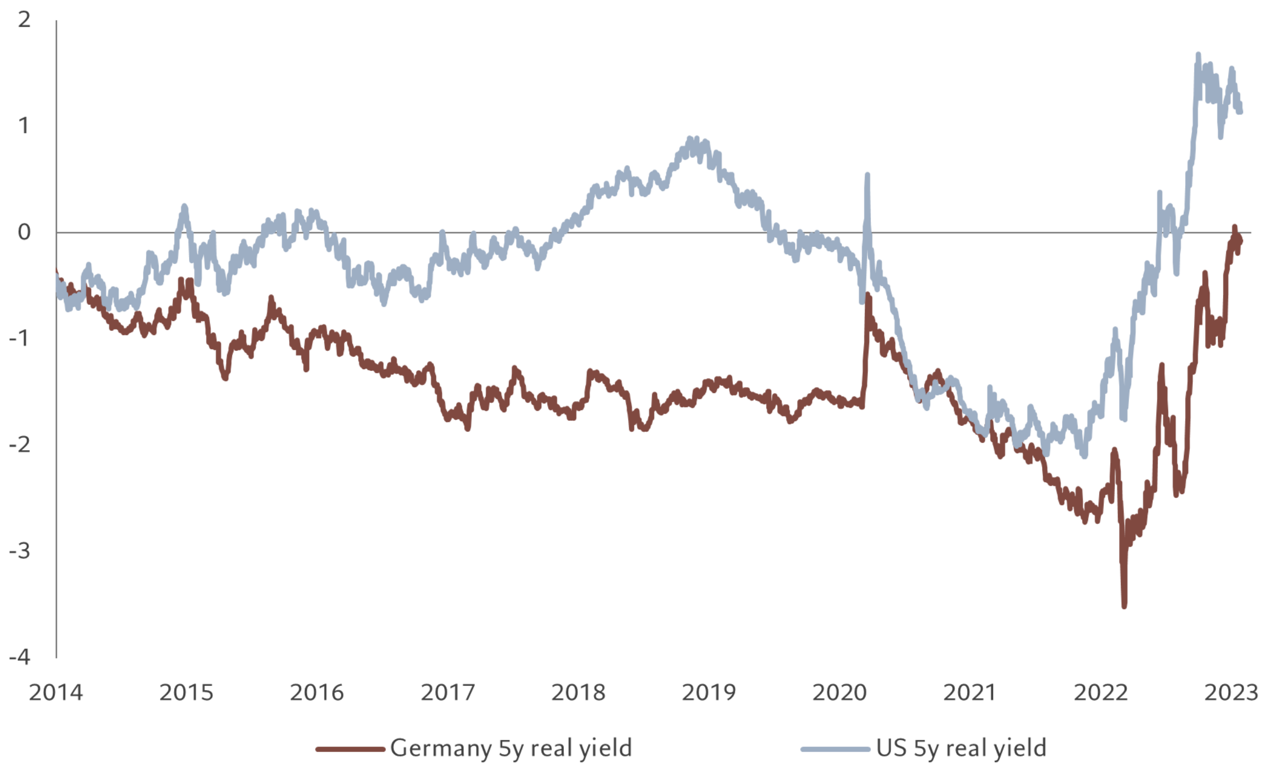
To paraphrase the economist John Maynard Keynes, when valuations change, we change our positions . It's a doctrine we've recently seen fit to apply to developed market government bonds. For the past several months, we have favoured US Treasuries over their European counterparts, largely in the expectation that the ECB would ramp up the pace of monetary tightening. European policymakers, we believed, had been too slow in raising interest rates to combat inflation, particularly when compared to the more aggressive Fed.

Yet with bond markets and monetary policy having recently shifted in the direction we envisaged, it is now time to reassess our stance. Take US Treasuries. They are not as cheap as they used to be. As the Fed comes to the end of its interest rate hike campaign, markets have begun to discount the possibility of the US central bank easing monetary policy again as soon as the end of the year. Testament to this is a steep a drop in yields on intermediate-maturity bonds. Five-year Treasury yields have fallen some 80 basis points since October; those for similar maturity bonds in Europe, by contrast, have headed in the opposite direction.

While we agree official rates in the US are approaching a peak, it is unlikely the central bank will want to take risks with inflation, particularly if labour markets remain buoyant. In other words, once it hits its target rate, the Fed will keep borrowing costs at that level for an extended period, for longer than the market is implying. To express this view, we have trimmed our exposure to US government bonds.

Fig. 4 - Positive real yields in Europe

US and German government bonds, real yields (%)



Source: Refinitiv DataStream, Pictet Asset Management. Data covering period 28.01.2013-25.01.2023.

Euro zone bond markets are similarly somewhat unmoored from fundamentals, but for different reasons. The ECB has in recent weeks gone to great lengths to burnish its inflation-fighting credentials. Speaking at the World Economic Forum in Davos in January, ECB president Christine Lagarde reaffirmed what some of her colleagues had expressed in late 2022: that interest rates would need to rise substantially to eradicate inflationary pressures.

In response, yields on European government bonds spiked, with the yield on 10-year German Bunds rising from 2 per cent prior to Lagarde's speech to about 2.25 per cent.

Perhaps more significant is the shift in inflation-adjusted yields - real yields on German bonds moved into positive territory for the first time since July 2011 (see Fig. 4). This repricing, which points to an extended period of monetary tightening in the euro zone, doesn't survive contact with reality, in our view. By many yardsticks, inflationary pressures in Europe appear set to moderate, with warm weather pushing gas prices to down around EUR50 per megawatt hour from a peak of just above EUR300 per megawatt hour in early September 2022. Then there's the lagged effect of earlier rate hikes on economic activity. Particularly on household spending. Already, mortgage rates across the single currency region have spiked. Since June 2021, average mortgage rates in Spain and Germany have risen from just above 1 per cent to 2.7 per cent and 3.6 per cent, respectively. Taking this into account, we have shifted from underweight to neutral European bonds – both for government and investment grade securities.

Elsewhere, we retain our overweight stance on emerging market local currency debt which should benefit from a steady decline in the US dollar. We also upgrade the Chinese renminbi from underweight to neutral as Beijing's loosening of Covid restrictions should give rise in an increase in investment inflows into the country.

04 Global markets overview: the new year starts with a bang

Global equities had a storming performance in January, posting one of the best monthly gains in decades. The MSCI World Index was up 6.5 per cent on the month in local currency terms, recovering a significant chunk of last year's 17 per cent drop.

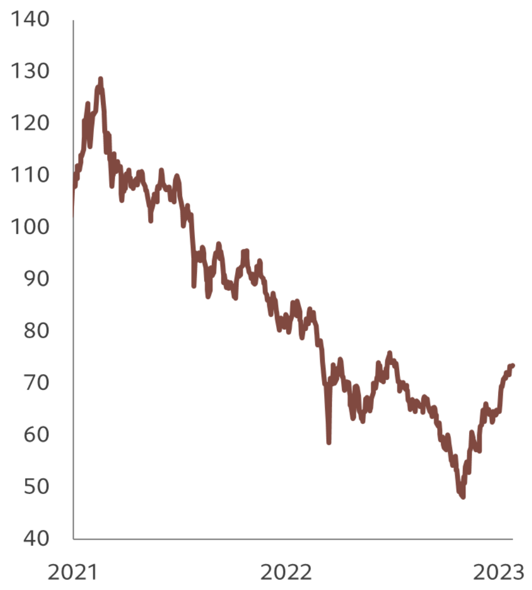
Slowing inflation, expectations of easier monetary policy later in the year and China's re-opening all helped feed investors' renewed appetite for risk. The standout region was the euro zone, whose equity markets were up a shade under 10 per cent. Emerging market equities kept pace with the US by gaining just over 6 per cent – all in local currency terms.

Growth stocks and cyclicals were bid – growth gaining some 9 per cent against just 4 per cent for value stocks, while small caps outperformed large caps. Communications stocks were up some 13 per cent per cent and IT gained 10 per cent on the month, while consumer discretionary was up nearly 14 per cent. All three sectors lost 30 per cent-plus during 2022. By contrast, energy was up just 2.2 per cent, lagging the rest of the market on oil and gas price weakness. Overall, commodities were down marginally during the month. Across sectors and investment styles, there was a clear trend of last year's winners losing ground and laggards gaining the most in the first month of 2023.

But it wasn't just equities – the rally stretched right across risk assets. Credit gained, with euro zone high yield up some 3 per cent on the month. In the US, both high yield and investment grade corporate bonds were up by just under 4 per cent. Emerging market bonds were up 4 per cent on the month, outpacing developed sovereign fixed income markets.

Expectations that the Fed is close to the top of its hiking cycle – markets point to it starting to cut in the second half of the year – undermined the dollar,

Fig. 5 - China's resurgence
MSCI China index



Source: Refinitiv DataStream, Pictet Asset Management. Data covering period 25.01.2018-25.01.2023.

which eased 1.4 per cent on the month. Gold, thanks in part to a weakening dollar, did well, gaining 6 per cent after a drab performance in 2022.

05 In brief

BAROMETER FEBRUARY 2023

Asset allocation

Although the global outlook is starting to brighten, many risks remain. We retain an overweight stance on bonds and an underweight on equities.

Equities regions and sectors

China re-opening should help domestic equity markets as well as those in the emerging world. We remain underweight US and European stocks.

Fixed income and currencies

We turn more positive on European bonds - both sovereign and investment grade credit.

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Written by

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