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GLOBAL ASSET CLASSES

We keep our neutral stance on equities and our underweight in bonds. Growth is improving but still fragile; markets are also vulnerable to risk of political shock in the euro zone.

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE (Maximum change ◀◀◀◀ ▷▷▷▷)
Equities			Equities			
Bonds		Bonds				
Cash				Cash		
Gold			Gold			
Oil					Oil	
USD					USD	

EQUITY REGIONS AND STYLES

We close our long position in Japan after the market's recent outperformance. The US is upgraded as growth momentum is strong and the policy mix right.

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE
Japan			Japan			◀
US				US		▷
Europe		Europe				
Pacific			Pacific			
Emerging			Emerging			
Mid & Small Cap		Mid & Small Cap				
Value			Value			

EQUITY SECTORS

Our allocation remains defensive with healthcare and consumer staples as our main overweights; financials in the euro zone are especially vulnerable to higher funding costs.

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE
Energy				Energy		
Materials			Materials			
Industrials		Industrials				
Consumer Disc			Consumer Disc			
Consumer Staples				Consumer Staples		
Healthcare					Healthcare	
Financials	Financials					
IT			IT			
Telecoms	Telecoms					
Utilities				Utilities		

FIXED INCOME

We continue to favour investment grade and high-yield debt, but move emerging market local currency bonds to neutral on concerns about potential currency weakness and heavy investor positioning.

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE
EUR Government			EUR Government			
EUR Inflation Link			EUR Inflation Link			
EUR Investment Grade				EUR Investment Grade		
EUR High Yield				EUR High Yield		
EMD Hard (USD)			EMD Hard (USD)			
EMD Local			EMD Local			◀

Markets over-react to improved growth

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

April 2013

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 2 April 2013

Global market overview

Equities gain as Cyprus debacle fails to deter investors

Developed equity markets rose, outpacing bonds, as concerns over the implications of Cyprus's bailout were outweighed by strong US data and signs of a pick-up in economic activity in other regions. The gains masked a wide dispersion in returns across both countries and sectors, however.

Although equities outperformed bonds, defensive sectors fared better than cyclical stocks, with health care, telecoms and consumer staples delivering the best returns. The preference for defensive equities was also evident when it came to country returns. Emerging market stocks fell over the month, further widening the gap in performance relative to their developed counterparts, while Swiss, German and UK stocks fared far better than peripheral European markets such as Italy and Spain, which both declined.

In fixed income, returns were positive for euro-based investors but negative for US dollar participants as the euro lost ground in the currency markets in the wake of the Cyprus bailout. Speculative-grade bonds proved to be the standout performers as investors showed no sign of losing their appetite for higher-yielding debt.

While the upward move in equities suggested markets had taken the bailout of Cyprus's banks in their stride, a spike in the cost of insuring against bank bond defaults testified to investor concerns over the terms of the deal. Credit default swaps on European banks rose by some 20 to 30 basis points over the month.

The fear among market participants is that the island's rescue package, which involved imposing heavy losses on depositors, might turn out to be policymakers' preferred template for future bank bailouts. Were this to be the case, it would potentially expose banking groups in Spain, Italy and Portugal to the risk of bank runs and possibly raise funding costs for all European banks.

Asset allocation

Keep neutral allocation to equities and underweight position in global bonds

We maintain our neutral stance on global equities and our short position in global government bonds as benign economic conditions are offset by the risk that central banks might withdraw stimulus too early.

We retain a long US dollar position even after its recent strong gains.

The improvement in the **business cycle** has been the biggest support to risk assets over the last few months. Our proprietary global leading indicators suggest growth momentum is at its strongest level in two years, with the improvement distributed evenly across all regions. The pick-up has been led by the US, where the combination of solid employment growth, rising house prices and recovery in investment spending has more than offset the negative impact of recent tax hikes. The euro zone, meanwhile, is still in recession but there are some encouraging signs, especially from Germany. Emerging markets growth has been resilient, even though recent data from China has been mixed.

But, while this picture appears encouraging, the rise in leading indicators may understate the vulnerability of the global economy, which is in the middle of a long healing process. When we compare the performance of global equities to the more muted improvement in growth proxies such as commodity prices and the economic surprises index, we find that, since the summer of last year, only half of the market's 25 per cent gain can be attributed to an upturn in the growth outlook. The underperformance of cyclical stocks versus defensive equities (see chart) also suggests that the growth outlook may be weaker than generally assumed. This means that should growth fail to gain momentum from here, or central banks further withdraw monetary support, a correction looks likely in the months ahead. A slowdown in US growth, a political accident in the euro zone or poor results in the upcoming corporate earnings season could prove to be catalysts for a market decline.

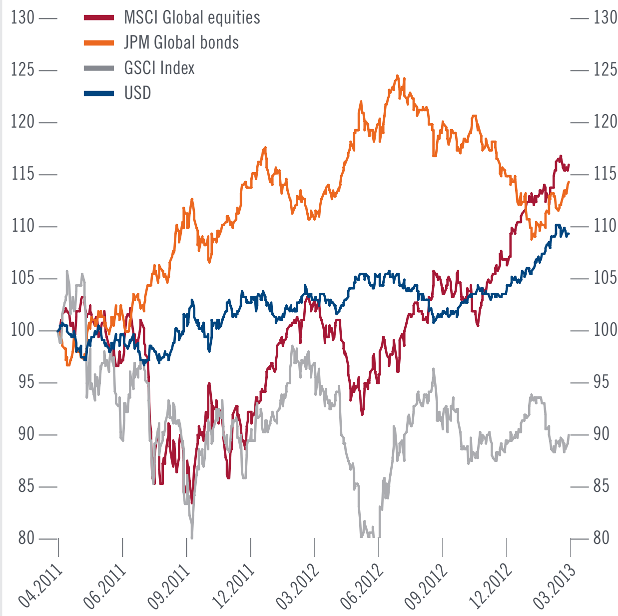
CYCLICALS' UNDERPERFORMANCE SUGGESTS RALLY DRIVEN BY FACTORS OTHER THAN GROWTH

Source: Thomson Reuters Datastream

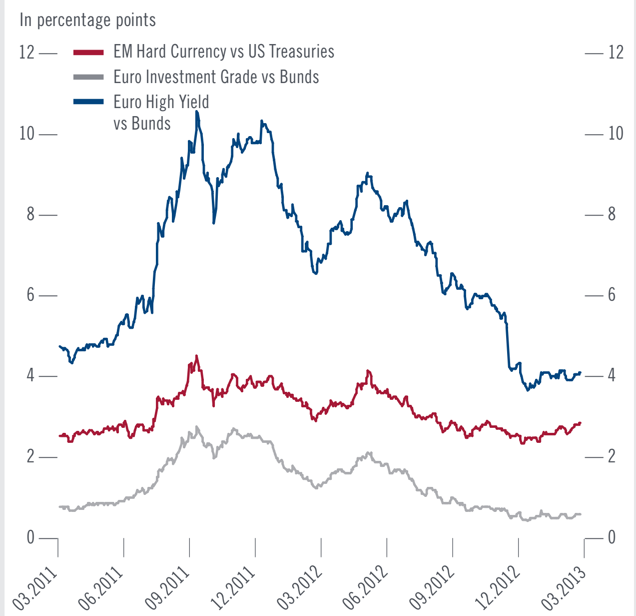
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

MAJOR ASSET CLASSES

PERFORMANCE: ASSET CLASSES

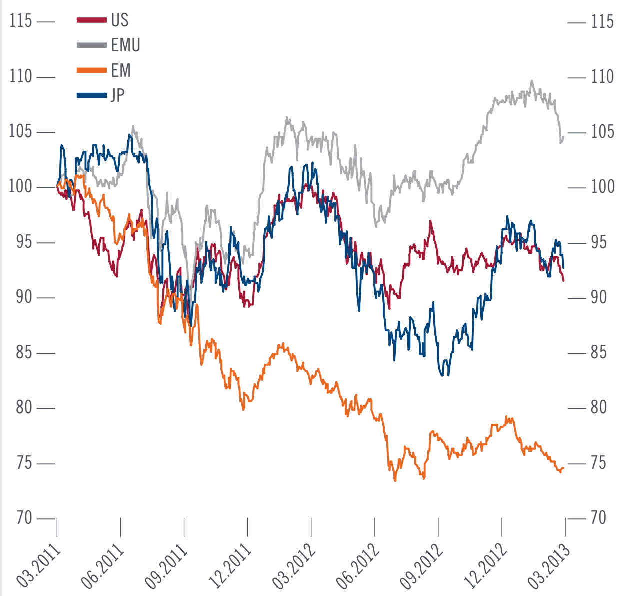


BONDS: ASSET CLASS SPREADS



EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE

GLOBAL EQUITY SECTOR ROTATION:
PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS



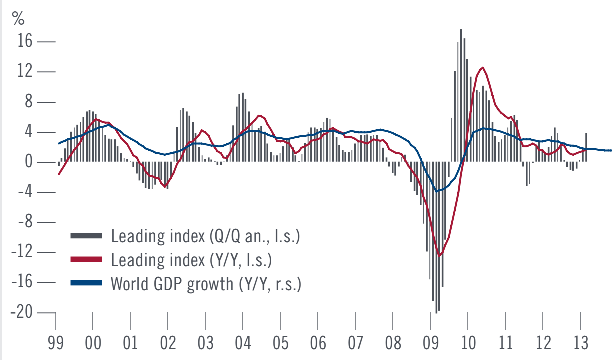
PERFORMANCE: CURRENCIES VS USD

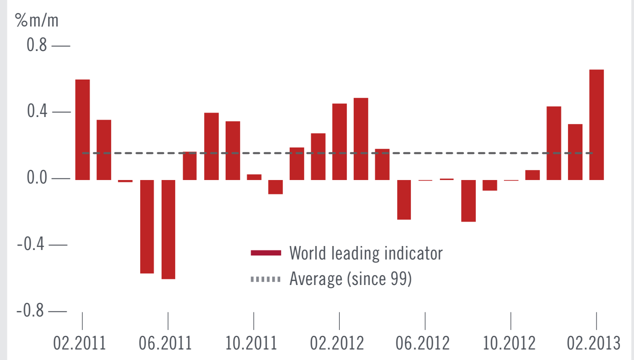
Source: Pictet Asset Management, Thomson Reuters Datastream

RISK BIAS INDICATORS

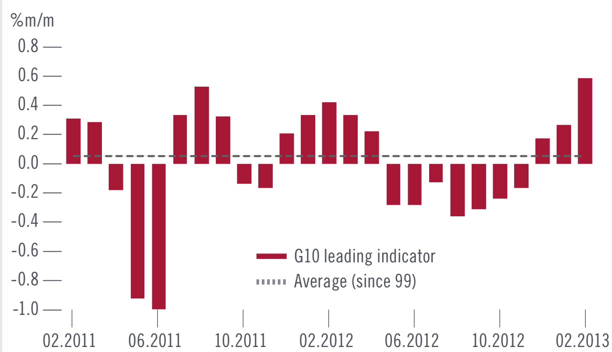
MONTHLY CHANGE Maximum change ◀◀◀◀ ▷▷▷▷	RISK-OFF –	NEUTRAL o	RISK-ON +
		Business cycle	Business cycle
		Liquidity	Liquidity
		Valuation	
		Sentiment	
		PAM strategy	

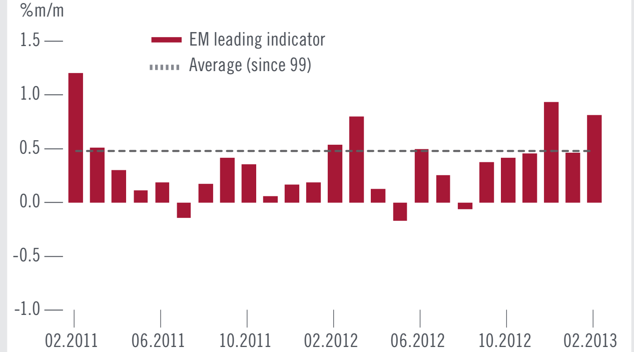
BUSINESS CYCLE: WORLD ECONOMIC ACTIVITY STILL IMPROVING





ECONOMIC MOMENTUM CONFIRMED IN G10 AND EMERGING COUNTRIES





Source: Pictet Asset Management, Thomson Reuters Datastream

VALUATION: EQUITY MARKETS AND SECTORS

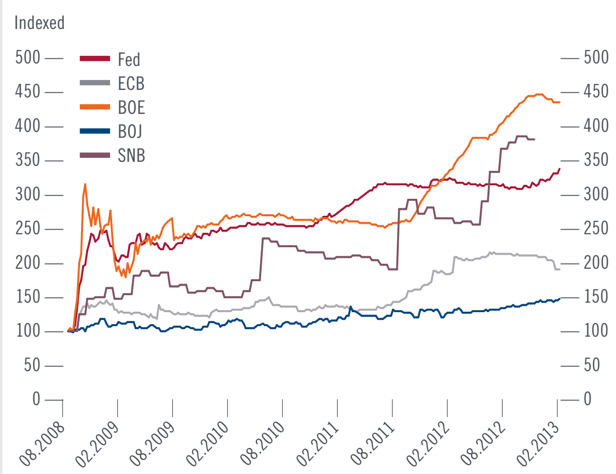
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH 2013	EPS GROWTH 2014	SALES GROWTH 2013	SALES GROWTH 2014	PE 2013	PE 12M	PB 2013E	P/SALES 2013E	DY 2013E
US	8%	11%	3%	5%	14.0	13.6	2.1	1.4	2.2%
Europe	7%	12%	3%	4%	12.2	11.9	1.5	0.9	3.8%
EMU	10%	14%	3%	3%	11.9	11.5	1.2	0.7	3.8%
Switzerland	8%	11%	15%	5%	15.2	14.8	2.4	2.0	3.2%
UK	5%	10%	1%	4%	11.5	11.2	1.7	1.0	4.0%
Japan	49%	13%	5%	3%	14.4	14.4	1.3	0.6	2.0%
EM	15%	11%	11%	7%	10.5	10.3	1.4	0.7	2.9%
NJA	17%	12%	13%	8%	11.5	11.2	1.5	0.7	2.7%
Global	11%	12%	5%	5%	13.2	12.8	1.7	1.1	2.8%

MSCI GLOBAL SECTORS	EPS GROWTH 2013	EPS GROWTH 2014	SALES GROWTH 2013	SALES GROWTH 2014	PE 2013	PE 12M	PB 2013E	P/SALES 2013E	DY 2013E
Energy	4%	8%	-1%	3%	10.5	10.3	1.3	0.7	3.2%
Materials	17%	17%	6%	5%	12.5	11.8	1.5	0.9	2.7%
Industrials	11%	13%	6%	5%	14.2	13.7	2.0	0.8	2.5%
Consumer Discretionary	17%	15%	7%	6%	14.7	14.2	2.3	0.9	1.9%
Consumer Staples	9%	10%	7%	5%	17.5	16.9	3.4	1.1	2.9%
Health care	1%	9%	4%	5%	14.8	14.4	2.8	1.6	2.4%
Financials	15%	11%	5%	5%	11.7	11.4	1.1	1.5	3.2%
IT	12%	13%	8%	7%	13.3	12.7	2.5	1.5	1.7%
Telecoms	6%	9%	2%	3%	13.1	12.9	1.8	1.2	4.8%
Utilities	9%	11%	14%	3%	14.5	14.4	1.3	0.8	4.3%

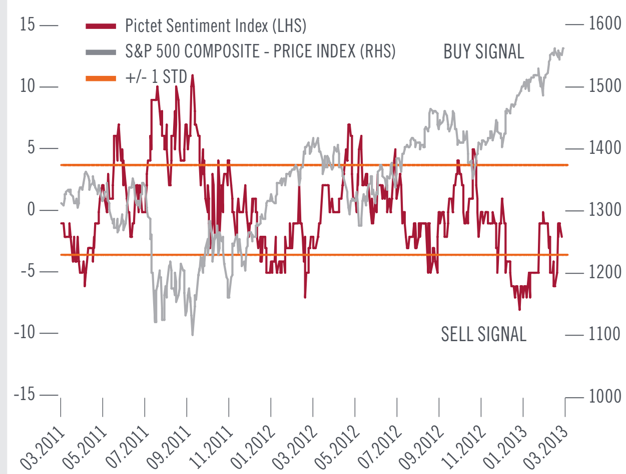
LIQUIDITY: STILL BOOSTED BY EASY MONETARY POLICY

SIZE OF CENTRAL BANKS' BALANCE SHEETS



SENTIMENT READING BACK TO NEUTRAL

PICTET SENTIMENT CYCLE INDEX



Our **sentiment** indicators are still in neutral territory, even after this month's equity rally. Investor sentiment, as captured by surveys and investment flows into equity funds, has come off recent peaks but measures of implied volatility – the cost of purchasing insurance against a market decline – remain close to historically low levels.

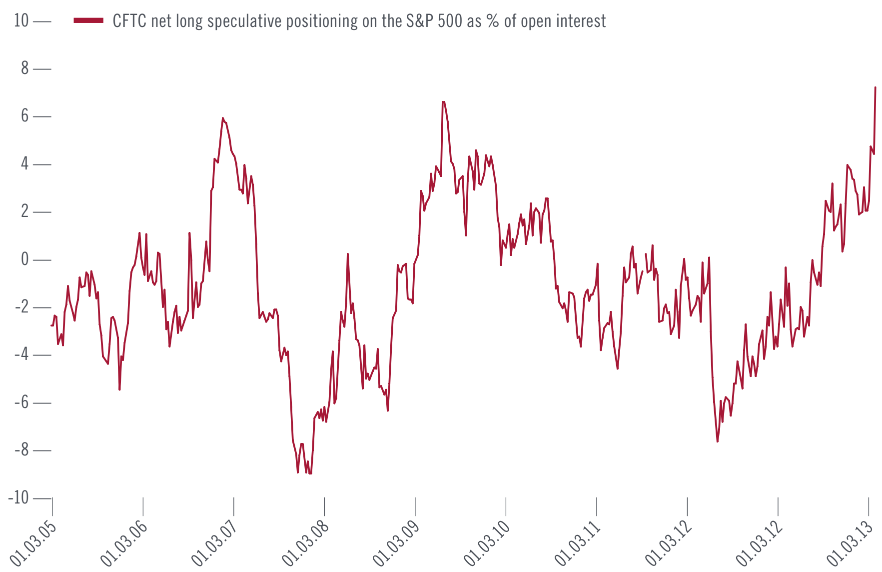
Also discouraging is the fact that net speculative positions on the S&P 500 index – a good contrarian indicator - have risen to a five-year high (see chart). Another negative technical signal comes in the form of a narrowing of the breadth of the market rally – there are now a smaller number of stocks either trading above their 50-day moving average or making new highs than before.

Looking at **valuations**, global equities appear fairly valued on a multiple of 12.8 times 12-month forward earnings. They retain their appeal relative to bonds, but with earnings downgrades now outnumbering upgrades, a combination of higher bond yields and higher equity prices has narrowed stocks' valuation gap to bonds to a two-year low. We struggle to see clear value in any of the major asset classes we monitor.

Our **liquidity** gauges continue to be supportive for risk assets, albeit less so than last month. We are concerned by the effective tightening of the European Central Bank's balance sheet (which comes courtesy of banks making early repayments of emergency loans) at a time of credit contraction. The sharp deceleration in US money supply is another warning signal. However, the US Federal Reserve has reiterated its commitment to buy USD 85 billion of bonds each month and we do not expect any significant change in this policy in the near future. The Bank of Japan, meanwhile, has confirmed its willingness to hit the new 2 per cent inflation target "as soon as possible" by buying long-dated bonds.

The bailout of Cyprus by the Troika (see our Flash Note on this topic published on 25 March) has so far been well received by investors but the repercussions of the bail-in of depositors and senior bank bondholders remain unclear. On the one hand, the rescue reduces moral hazard in the long term. On the other, it risks triggering bank runs in other countries. We continue to believe that the euro zone – faced with political deadlock in Italy and a looming election in Germany - will remain a source of negative political developments in the months ahead.

SPECULATIVE INVESTORS EXTEND LONG POSITION IN US EQUITIES



Source: Pictet Asset Management

Equity region and sector allocation

Play safe... buy US and reduce Japan to neutral

We close the long Japan position initiated in November. We see little further upside after a 10 per cent outperformance over global equities (or 27 per cent in local currency terms) and early signs that Japan's macroeconomic and earnings momentum may have peaked.

Moreover, Japan is no longer cheap on our scorecard – on a price-earnings ratio of 14.4 times 12-month forward earnings, the market now trades at a 12 per cent premium to global equities. We would also point out that Japanese equities tend to perform less strongly after the close of the fiscal year, which ends in March.

We upgrade the US to a single overweight. Growth momentum is strong, the fiscal and monetary policy mix is appropriate, and US corporations, including banks, exhibit better earnings visibility and more solid fundamentals than their global peers. A significant rise in share buybacks could provide an additional boost.

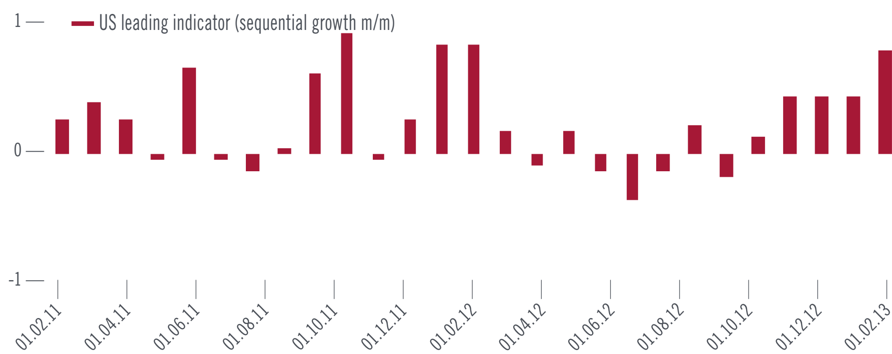
We keep our underweight in Europe where the risk of a policy mistake, a political accident or economic stagnation remain relatively high. Valuations are not especially cheap, earnings momentum is deteriorating and the euro still trading above its purchasing power parity of USD 1.25.

From a strategic point of view, the sharp underperformance of emerging market equities (down some 20 per cent since September 2010) could offer a good entry point into the asset class but we feel that a turn in relative economic and earnings momentum would be required for us to become more bullish.

On sectors, we maintain our defensive tilt with health care and consumer staples – the best performing sector year to date – the biggest overweights. We are also overweight the energy sector – which trades at a significant discount to the oil price and offers a dividend yield of around 3 per cent on a global basis.

We maintain our short position in financials (the bail-in of senior bondholders and depositors will raise the cost of capital for European banks), telecoms and industrials. While supported by strong consumer spending in the US, consumer discretionary stocks trade at a record high against the market and are now the most expensive sector globally on our scorecard. For this reason, we retain our neutral position on the sector.

US LEADING INDICATORS CONTINUE TO IMPROVE



Source: Pictet Asset Management

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Fixed Income

High yield overweight remains in place

We retain our overweight in corporate bonds as persistently low interest rates will continue to fuel a "search for yield". We stay neutral government bonds, where we favour Germany but are underweight France, Italy and Belgium.

This month, we have decided to scale back our exposure to local currency emerging market debt – which has been a prominent feature in our fixed income allocation in recent months – to neutral from overweight. We have seen more divergent trends between emerging market currencies, reflecting the fact that the countries of the developing world are at different points of the economic cycle. Currency weakness has become more of a concern. Technical indicators also highlight risks: investor positioning in local currency debt has been exceptionally bullish, increasing the scope for a market correction. A possible revival of the euro zone debt crisis – a scenario we cannot rule out – presents us with an additional reason to reduce our exposure to the asset class.

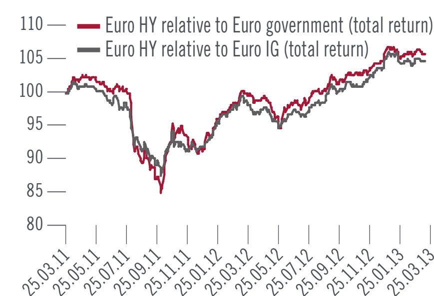
Elsewhere, we continue to overweight corporate high-yield bonds. Although yields on speculative-grade debt remain low by historical standards, spreads continue to offer investors more than sufficient compensation against risks inherent in speculative-grade securities.

Hovering at close to 550 basis points, the yield spread remains some distance above both the levels seen just before the credit crisis and the historic low of just under 200 basis points. Factor in the prospect of below-average bond default rates – we expect default rates to remain in the low single-digit range over the course of 2013 – and valuations still appear attractive at this juncture. The economic backdrop of low rates is also benign for high-yield debt.

To protect against the threat of a deterioration of the growth outlook in Europe and the risk of political instability, we maintain our preference for German Bunds and US Treasuries in our global portfolios.

In currencies, our positioning is guided by our views on the growth differentials that will likely open up among the world's major economies. We hold underweight positions in the currencies of economies that may struggle to deliver sustainable economic growth - the euro, the pound sterling and the Japanese yen are our main underweights in the developed world. We continue to favour the US dollar. Even though US growth is modest by historical standards, it is expanding at a faster rate than other parts of the developed world. We are also overweight the Mexican peso and Canadian dollar – currencies which should do well on a trade-weighted basis should US growth continue.

HIGH YIELD BONDS HAVE OUTPERFORMED OTHER FIXED INCOME ASSET CLASSES



Source: Merrill Lynch

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Pictet Asset Management

ABOUT THE PSU

The Pictet Asset Management Strategy Unit (PSU) is the investment group responsible for providing asset allocation guidance across stocks, bonds, cash and commodities.

Each month, the PSU sets a broad policy stance based on its analysis of:

- **business cycle:** proprietary leading indicators, inflation
- **liquidity:** monetary policy, credit/money variables
- **valuation:** equity risk premium, yield gap, multiples vs. history
- **sentiment:** Pictet sentiment index (investors' surveys, tactical indicators)

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