

	UNDERWEIGHT –	NEUTRAL ○	OVERWEIGHT +	MONTHLY CHANGE Maximum change ◀◀◀ ▶▶▶
GLOBAL ASSET CLASSES We downgrade equities as all our main indicators point to a deterioration in the outlook for risk assets. Bonds are tactically upgraded to neutral after the recent sell-off.				
EQUITY REGIONS AND STYLES US equities offer the best earnings visibility, supported by the right mix of fiscal and monetary policy. The outlook for Europe remains clouded by weak growth and a tightening monetary environment.				
EQUITY SECTORS We maintain a slightly defensive tilt, favouring healthcare, consumer staples and utilities.				
FIXED INCOME Investment-grade bonds are downgraded to neutral as increased volatility in benchmark bond yields and tight spreads leave little room for outperformance.				

Time to turn more cautious

Pictet Asset Management **Strategy Unit**

Monthly euro investor outlook on a 3 month view

Barometer

June 2013

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 3 June 2013

Global market overview

Investors overcome Fed fears

Developed equities rallied in May as investors shrugged off speculation that the US Federal Reserve might soon look to scale back bond purchases. Stocks suffered a bout of selling pressure earlier in the month as minutes from the Fed's April meeting suggested some members of its rate-setting committee see justification in slowing down the pace of quantitative easing. But markets soon regained their poise after both the European Central Bank and the Bank of Japan said monetary stimulus would remain in place.

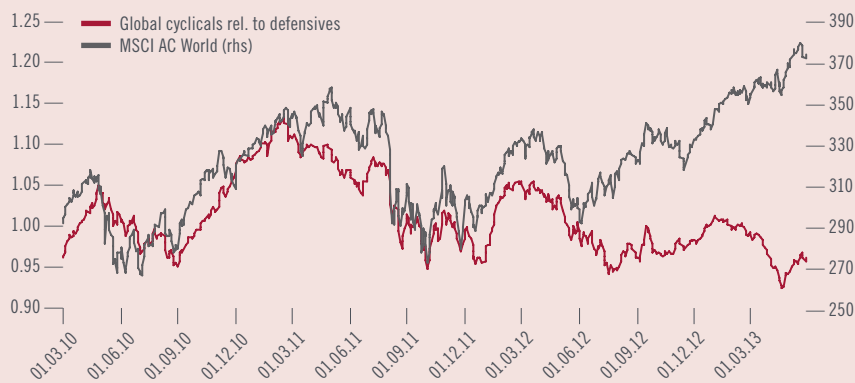
The pattern of stock returns across countries and sectors was however noticeably different from what was seen the previous month. In contrast to April, cyclical stocks were the best performers, with consumer discretionary, information technology and industrials outpacing the broader market. Utilities, telecom and consumer staples were the laggards, snapping a trend that has been in place for several months (see chart).

Emerging market stocks underperformed their developed counterparts

as investors were unnerved by news that China's manufacturing index had fallen to its lowest reading since October – indicating that its economic growth rate is falling towards 7.5 per cent. The sell-off was characterised by a stark underperformance of BRIC stocks, which lagged the returns of smaller markets by a wide margin.

In fixed income markets, most asset classes ended the month in negative territory. US Treasury yields ratcheted higher while investment-grade bonds sold off in spite of falling inflation expectations. Elsewhere, eurozone fixed income markets received some good news in the shape of an interest rate cut from the ECB, a credit rating upgrade for Greece from Fitch and an oversubscribed EUR3 billion bond auction from Portugal. In the currency markets, the US dollar was the standout performer – commodity-related currencies such as the Australian dollar and clutch of emerging market currencies weakened.

CYCLICAL STOCKS BUCK TREND TO OUTPERFORM DEFENSIVE SECTORS



Source: Bloomberg

Asset allocation

Downgrade equities to underweight, raise bonds to neutral

We believe global equity markets are about to enter a more challenging phase, and are therefore downgrading stocks to underweight from neutral. At the same time, in response to a near 50 basis point rise in US Treasury yields, we take profits from our underweight position on government bonds and move to a neutral stance. This is a purely tactical decision as we believe that government bonds in developed markets have already entered what will become a secular bear market.

Elsewhere, we stick to our long position in the US dollar: despite its trade-weighted gain of some 8 per cent since September, the currency remains fairly valued and should continue to draw support from relatively resilient US economic growth, the country's improving deficit and persistent speculation that the Fed may scale back its bond purchases.

Almost all of our indicators suggest a more cautious positioning towards risk assets over the next one to three months is justified. Weaker leading economic indicators, higher equity valuations and excessively bullish investor sentiment raise the risk of a correction in equity prices.

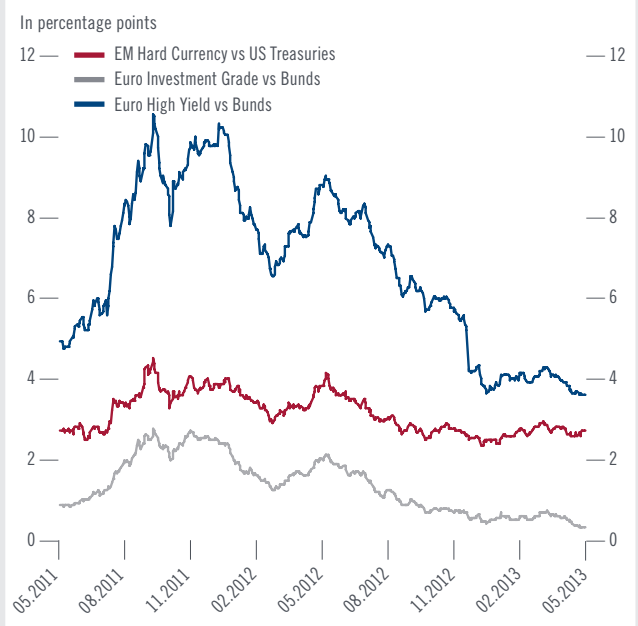
Our leading indicators for the month strongly suggest that the **business cycle** has deteriorated in all regions excluding Japan. The loss of momentum is particularly evident in the US, where our lead indicator has fallen the most in two years in April, primarily on the back of weak investment. China is another source of concern, reflected

MAJOR ASSET CLASSES

PERFORMANCE: ASSET CLASSES

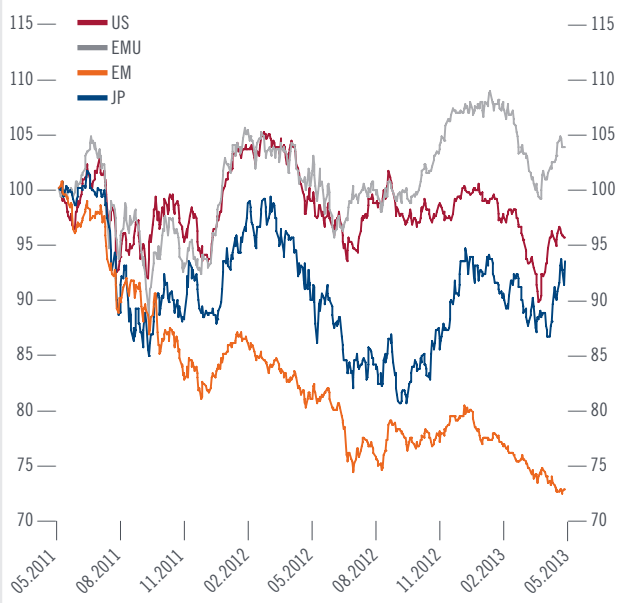


BONDS: ASSET CLASS SPREADS



EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE

GLOBAL EQUITY SECTOR ROTATION:
PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS



PERFORMANCE: CURRENCIES VS USD

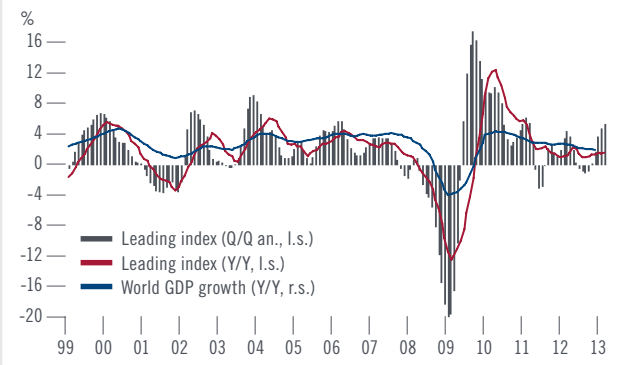


RISK BIAS INDICATORS

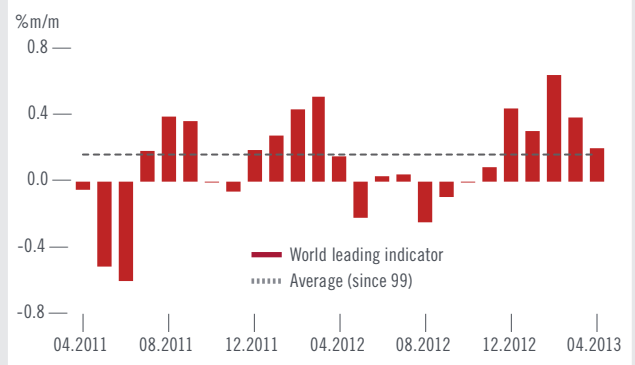
MONTHLY CHANGE Maximum change		RISK-OFF -	NEUTRAL o	RISK-ON +
◀◀◀◀	▶▶▶▶			
◀		Business cycle		
◀		Liquidity		
		Valuation		
◀◀		Sentiment		
◀		PAM strategy		

BUSINESS CYCLE: WORLD ECONOMIC ACTIVITY SLOWING

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

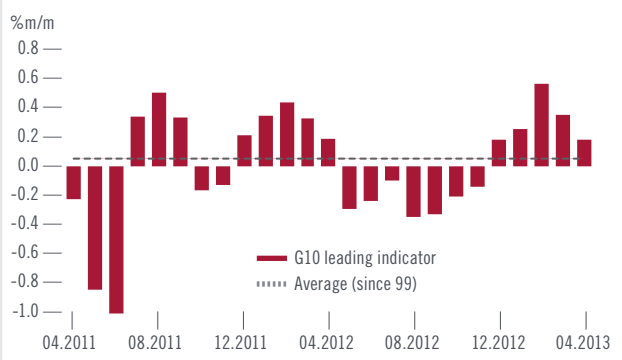


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

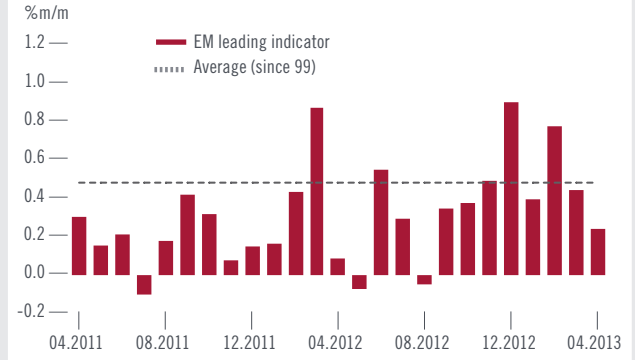


ECONOMIC MOMENTUM DECELERATES IN G10 AND EMERGING ECONOMIES

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



VALUATION: EQUITY MARKETS AND SECTORS

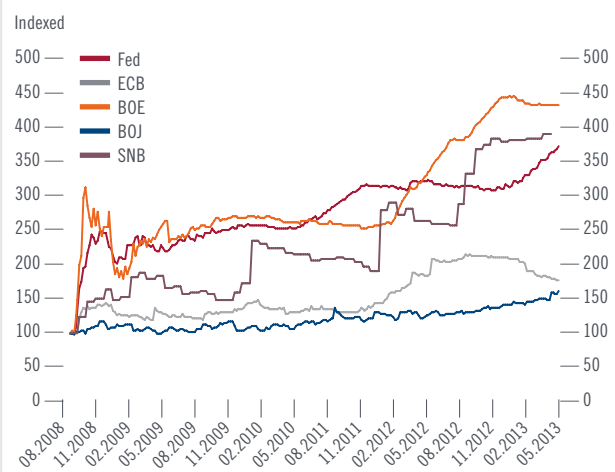
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH		SALES GROWTH		PE		PB 2013E	P/SALES 2013E	DY 2013E
	2013	2014	2013	2014	2013	12M			
US	7%	11%	2%	4%	15.0	14.3	2.2	1.5	2.1%
Europe	5%	12%	0%	4%	13.1	12.4	1.6	1.0	3.6%
EMU	3%	14%	0%	3%	13.0	12.2	1.3	0.8	3.6%
Switzerland	8%	11%	4%	5%	15.8	15.1	2.5	2.1	3.1%
UK	3%	10%	1%	4%	12.3	11.8	1.8	1.1	3.8%
Japan	56%	13%	6%	3%	13.5	14.9	1.3	0.6	1.9%
EM	15%	12%	10%	7%	10.7	10.2	1.4	0.7	2.9%
NJA	18%	13%	12%	8%	11.7	11.2	1.5	0.7	2.6%
Global	10%	12%	4%	5%	14.0	13.3	1.8	1.1	2.7%

MSCI GLOBAL SECTORS	EPS GROWTH		SALES GROWTH		PE		PB 2013E	P/SALES 2013E	DY 2013E
	2013	2014	2013	2014	2013	12M			
Energy	2%	8%	-1%	2%	10.8	10.5	1.3	0.7	3.2%
Materials	7%	18%	5%	5%	13.3	12.3	1.5	0.9	2.8%
Industrials	10%	14%	5%	5%	15.0	14.2	2.2	0.8	2.4%
Consumer Discretionary	16%	16%	7%	6%	15.9	14.9	2.5	1.0	1.8%
Consumer Staples	9%	10%	6%	5%	18.3	17.4	3.5	1.1	2.8%
Health care	1%	9%	5%	5%	16.2	15.6	3.1	1.8	2.2%
Financials	15%	10%	3%	5%	12.2	11.7	1.2	1.6	3.1%
IT	11%	13%	6%	7%	14.0	13.2	2.6	1.6	1.7%
Telecoms	5%	9%	3%	3%	13.9	13.5	1.9	1.2	4.6%
Utilities	18%	13%	0%	3%	15.3	14.8	1.3	0.8	4.2%

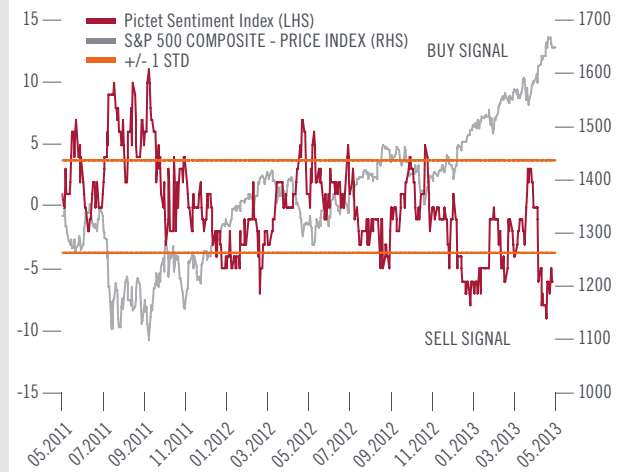
LIQUIDITY: STILL BOOSTED BY EASY MONETARY POLICY

SIZE OF CENTRAL BANKS' BALANCE SHEETS



SENTIMENT INDICATOR IN SELL TERRITORY

PICTET SENTIMENT CYCLE INDEX



in the International Monetary Fund's downgrade of China's GDP growth forecast for this year and next to 7.75 per cent. But China's slowing economy is not the only problem – so too is the lack of stimulus from the country's government, which now looks unlikely to take action until growth approaches 7 per cent.

Another dark cloud on the horizon for the global economy is the growing possibility that the Fed's asset purchase programme – currently running at USD85 billion per month – might soon begin to taper off.

Although we continue to believe that growth is too weak for the Fed to rein in liquidity at this stage, it remains a risk nevertheless. One bright spot in our business cycle readings, however, has been the sharp decline in inflation (see chart) in all regions. This has supported consumer spending power and has expanded the room to manoeuvre for central banks.

Liquidity conditions remain on balance supportive, thanks largely

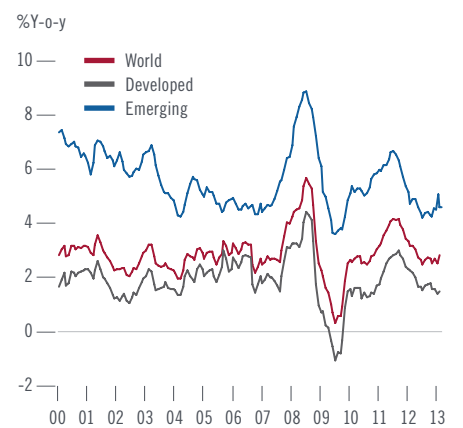
to the persistence of extremely loose monetary policies. That said, liquidity is not as abundant as it has been in recent months.

Despite its recent interest rate cut, the ECB is still a laggard when it comes to monetary easing as its balance sheet continues to contract. While monetary policy is likely to be eased further, the concern we have is that bank lending has barely grown in the US since the end of last year and is still contracting in parts of Europe. This suggests loose monetary policies are struggling to have the desired stimulative impact on the economy.

When it comes to **valuations**, the appeal of equities relative to bonds has diminished somewhat thanks to a combination of rising stock prices and an increase in bond yields. The gap in equity earnings/bond yields has reduced to about 5 per cent across all major regions (although it is still above the long-term average).

We would also point that with global stocks trading at around 13.3

INFLATION FALL A BRIGHT SPOT IN GLOBAL ECONOMY

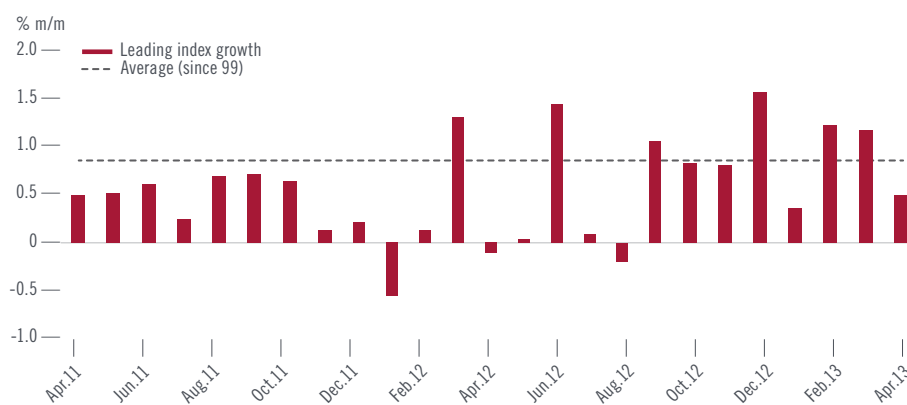


Source: Thomson Reuters Datastream

times forward earnings – close to the historical average – they are no longer cheap. What is more, the upward move in stocks has not been accompanied by an improvement in other economic growth proxies, such as commodity prices, which suggests that a market correction is due.

Meanwhile, our **sentiment** indicators have turned more bearish for equities this month. Investor sentiment, as captured by surveys and investment flows into equity funds, indicate a strong shift into equities while the very low levels of implied volatility – effectively the cost of insuring against a sharp market correction – hints at a high degree of investor complacency. Our proprietary sentiment indicator gives an outright sell signal for equities and net long positions in equities among speculative investors remain close to historical highs.

CHINA'S LEADING ECONOMIC INDICATORS SHOW RENEWED ECONOMIC WEAKNESS



Source: Thomson Reuters Datastream, Pictet Asset Management

Equity region and sector allocation

Stay cautious. Overweight defensive markets and sectors

In our regional equity portfolio we maintain our long US/short Europe position. The US market continues to outperform – year-to-date US equities are up 16 per cent in USD terms compared to a gain of 8 per cent for European stocks – and this has been due to stronger economic growth, resilient corporate earnings growth and the right mix of fiscal and monetary policy. For international investors, the appeal of US stocks is further boosted, in our view, by what we see as a future appreciation of the US dollar. Although US equities are not cheap – their price-to-earnings ratio of 14 means they currently trade at an 8 per cent premium to global stocks – their defensive risk-return profile is superior to that of any of other major market.

By contrast, European equities suffer from weak growth, a relatively strong euro and the fact that bank lending to non-financial corporations is contracting, down some 3 per cent year-on-year. At the same time, the ECB appears divided on what course of action it should take while earnings momentum among European companies remains very negative. Against this backdrop, European stocks are not cheap enough and a 12 per cent consensus EPS growth forecast for 2014 seems optimistic.

Elsewhere, the recent sell-off in Japanese equities – which are down 15 per cent from their peak on 23 May – potentially offers a good entry point into a market that

benefits from stronger economic and earnings momentum. Even so, valuations remain a concern while the boost companies have received from the weaker yen might soon fade, particularly as some government officials have issued warnings on the risk posed by the currency's rapid depreciation.

We remain attracted to the long-term potential of emerging markets but the recent slowdown in economic growth is a warning sign that is too strong to ignore, overshadowing the asset class's attractive valuations.

On sectors, we maintain our defensive tilt with health care and consumer staples as our biggest overweights. We do not believe the recent outperformance of cyclical stocks can continue as it is likely to have been the result of profit-taking on defensive stocks, which have seen exceptional gains this year. We are attracted to consumer discretionary stocks as lower inflation should boost consumer spending but high valuations prevent us from shifting from our neutral stance. We maintain our underweight position in financials (lending growth is decelerating in the US while European banks are still in debt-reduction mode) and industrials, a sector that is exposed to renewed global economic weakness and deteriorating capital spending in the US. Technology is the cheapest sector on our scorecard and we would consider an upgrade once economic conditions improve.

Fixed Income

Scaling back on investment-grade credit

In our fixed income portfolio, we retain a preference for spread products over government bonds.

However, we cut back our exposure to investment-grade bonds, shifting our stance on the asset class to neutral from overweight. The risk-reward profile for high-grade bonds has deteriorated in recent weeks as spreads continue to hover close to historically low levels.

At these valuations, investment-grade bonds offer little appreciation potential irrespective of any change in economic conditions. Should government bond yields rise due to an improvement in growth, high-grade bonds would likely suffer an even heavier sell-off. And in the event of a further slowdown in growth, the low risk premium offered by investment-grade debt would almost certainly serve to limit the asset class's defensive qualities.

We however retain our higher-than-index exposure to high-yield debt. Yields on speculative-grade bonds may be around their lowest levels on record but spreads continue to offer investors sufficient protection from any deterioration in the underlying credit quality of the asset class. If anything, the credit profile of the market has remained stable, as an expanding circle of borrowers

have managed to raise funds in the primary market to extend the duration of their liabilities.

What is more, with central bank stimulus likely to remain in place for some time, investors will continue to gravitate towards higher-yielding assets.

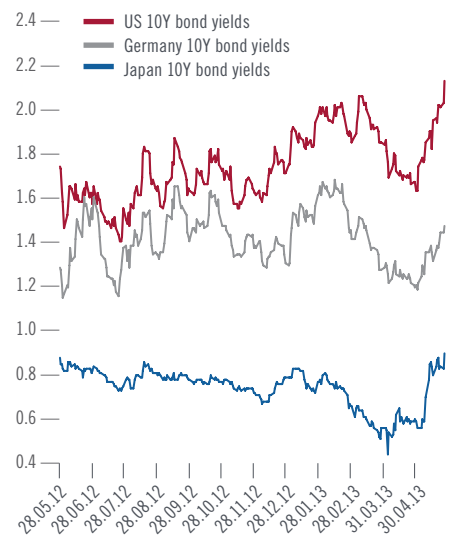
However, we are keeping a close eye on issuance in this area – European high-yield companies have issued roughly EUR47 billion of debt (gross) so far this year, which is nearly double last year's level.

We remain neutral emerging market local and hard currency debt. On currencies, we retain a preference for the US dollar, in particular against the euro – reflecting relative economic performance as well as the single currency's high valuation. We also remain bearish on the yen, mostly due to the large scale of the coming BoJ balance sheet expansion, and the political resolve to continue with the current policy stance. For EM currencies, the risks remain tilted to the downside.

Olivier Ginguené, *Chairman*
Pictet Asset Management Strategy Unit

Luca Paolini, *Chief strategist*
Pictet Asset Management

UPGRADING GOVERNMENT BONDS TO NEUTRAL FOLLOWING MAY SELL-OFF



Source: Thomson Reuters Datastream

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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