PICTET
1805

	UNDERWEIGHT –	NEUTRAL ○	OVERWEIGHT +	MONTHLY CHANGE (Maximum change ◀◀◀◀ ▷▷▷▷)

GLOBAL ASSET CLASSES
We keep a positive stance on equities on improving economic momentum and prospect of further central bank monetary support; oil is downgraded to neutral.

Global asset classes	Underweight	Neutral	Overweight	Monthly change
Equities			Equities	
Bonds	Bonds			
Cash		Cash		
Gold		Gold		
Oil		Oil		◀
USD			USD	

EQUITY REGIONS AND STYLES
European equities remain our top picks as liquidity conditions are set to improve further and growth momentum is also expected to stabilise.

Equity regions and styles	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
We upgrade consumer discretionary to single overweight as lower oil prices and improving labour markets should boost consumer spending; IT moves down to single underweight.

Equity sectors	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 remain overweight both local and hard currency EM debt which benefit from investor demand for higher yield and improving emerging economies.

Fixed income	Underweight	Neutral	Overweight	Monthly change
EUR Government	EUR Government			
EUR Investment Grade	EUR Investment Grade			
EUR High Yield		EUR High Yield		
EMD Hard (USD)			EMD Hard (USD)	
EMD Local			EMD Local	
EM Corporate		EM Corporate		

Equities to outshine bonds into year-end

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

December 2014

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 1 December 2014

Global market overview

Stocks outperform bonds; oil extends losses

World stocks ended the month higher, underpinned by expectations that global policymakers would take necessary measures to avoid deflation and support growth. Following the Bank of Japan's monetary easing last month, the People's Bank of China cut its benchmark interest rates for the first time in more than two years and hinted that it was ready to ease further to head off slowing inflation. The European Central Bank also said it would step up asset purchases to revive the flagging euro zone economy.

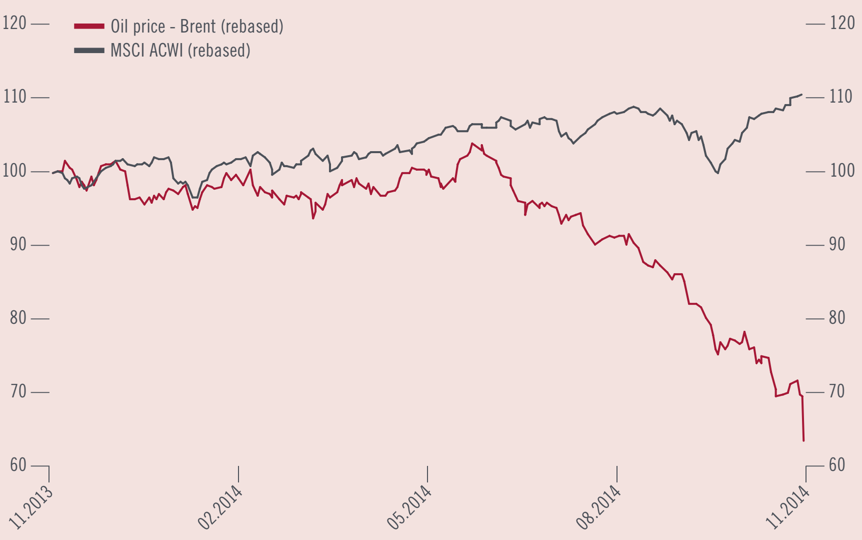
US stocks outperformed Europe, Japan and emerging markets as economic data pointed to strong consumer spending and manufacturing activity. Emerging markets were broadly flat as gains in South Africa, Turkey and Indonesia were offset by losses in Russia, Brazil and Korea.

Fixed income markets ended the month flat to negative, with US government and investment grade bonds outperforming their high yield and emerging counterparts. In the euro zone, the prospect of fresh ECB easing pushed the region's government bond yields to record lows. Both local and hard currency emerging debt slipped, weighed by slow growth in the developing world.

Oil prices extended their decline, falling nearly 19 per cent on the month to hit a four-year trough below USD75 a barrel (see chart). Oil has slumped nearly 40 per cent since June as concerns have intensified over weak demand on the back of sluggish global growth and ample supply. OPEC's decision to refrain from cutting output at its November meeting added momentum to the sell-off. Falling oil prices lifted consumer discretionary stocks, which rose more than 5 per cent on the month.

In currency markets, the USD rallied further against major and emerging currencies on expectations that strong US growth would spur the Federal Reserve to begin raising interest rates next year. The USD hit a seven-year high of near JPY119 after data showed Japan's economy had slipped back into recession, raising the prospect of more BoJ easing next year. The EUR hit a 28-month low below USD1.24, bringing its losses this year to nearly 10 per cent. The Russian rouble was the worst performing currency, falling more than 13 per cent on the month, weighed by slowing growth and falling oil prices.

STOCKS RISE AS OIL PRICES FALL



Source: Thomson Reuters Datastream

Asset allocation

Maintaining overweight stance in equities and USD

We keep our overweight stance in equities as expectations for further central bank monetary support, falling oil prices and improving economic momentum in the US and emerging economies are likely to underpin risk appetite into the New Year. Oil is downgraded to neutral. We remain underweight bonds and overweight the USD but stay neutral on cash.

Our **business cycle** readings show a slight improvement in global economic momentum. The US is leading the way, with a decline in oil prices bolstering consumer confidence, which rose to its highest level since 2007 (see chart on p6). Manufacturing activity indices also increased to their strongest levels in three years, while the labour market has improved further. This broad-based strength suggests the US economy can grow 3 per cent on an annualised basis over the next 6 months, after expanding at a healthy 3.9 per cent annual pace in the third quarter.

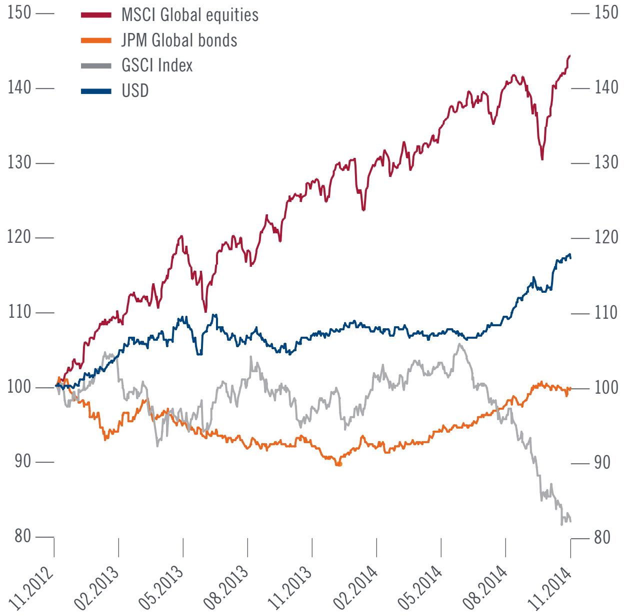
But even if growth picks up, the Federal Reserve is unlikely to rush into raising interest rates as inflationary pressures remain modest in the short term. This is partly because wage growth – which we expect to rise over the next year from its current 2 per cent pace – will take time to translate into consumer price inflation. (History shows it can take as long as 18 months). We expect core PCE (personal consumption expenditures price index) to reach 2 per cent by the end of the second quarter from the current 1.6 per cent.

In Europe, economic momentum has stabilised. While manufacturing activity remains sluggish, consumer

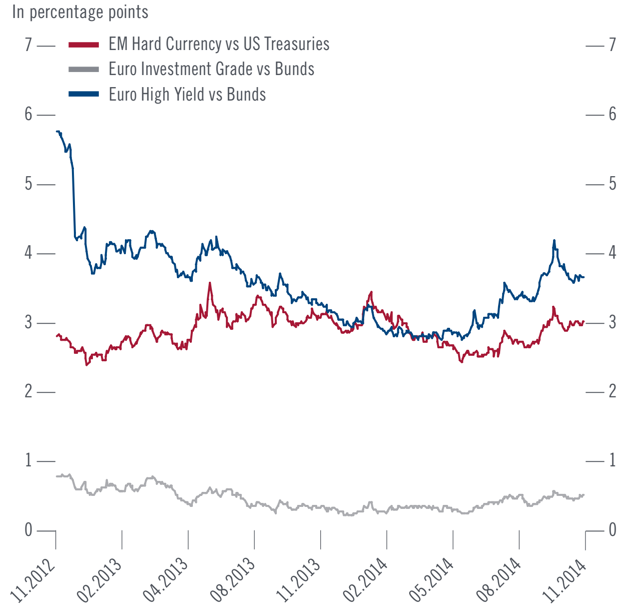
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

MAJOR ASSET CLASSES

PERFORMANCE: ASSET CLASSES

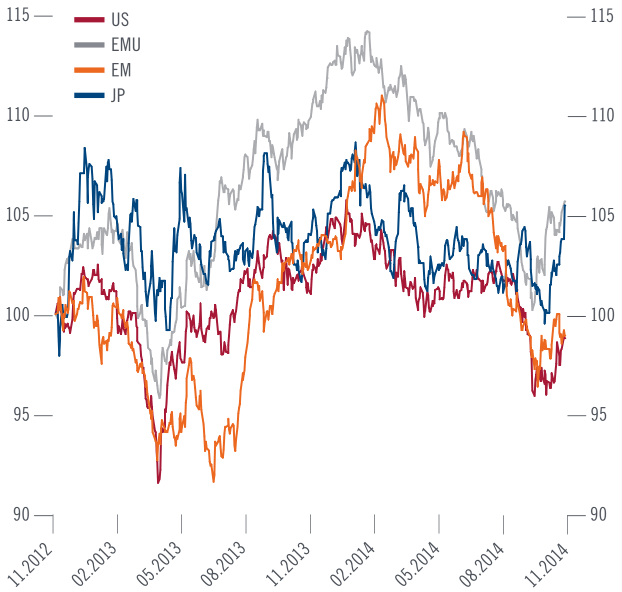


BONDS: ASSET CLASS SPREADS

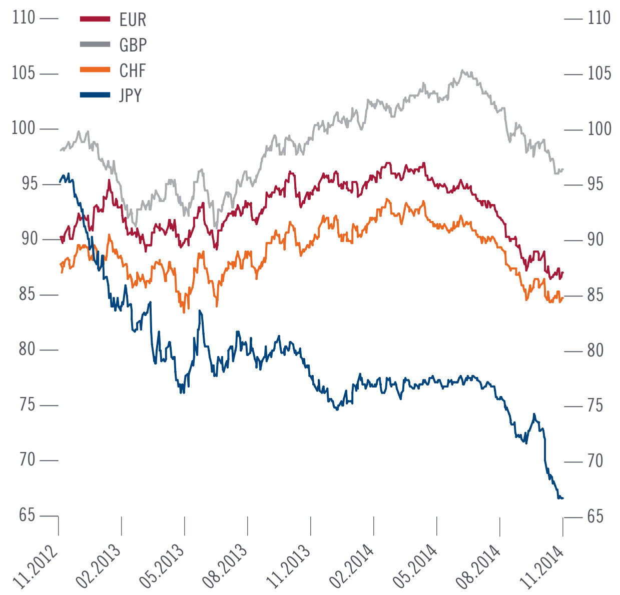


EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE

GLOBAL EQUITY SECTOR ROTATION:
PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS

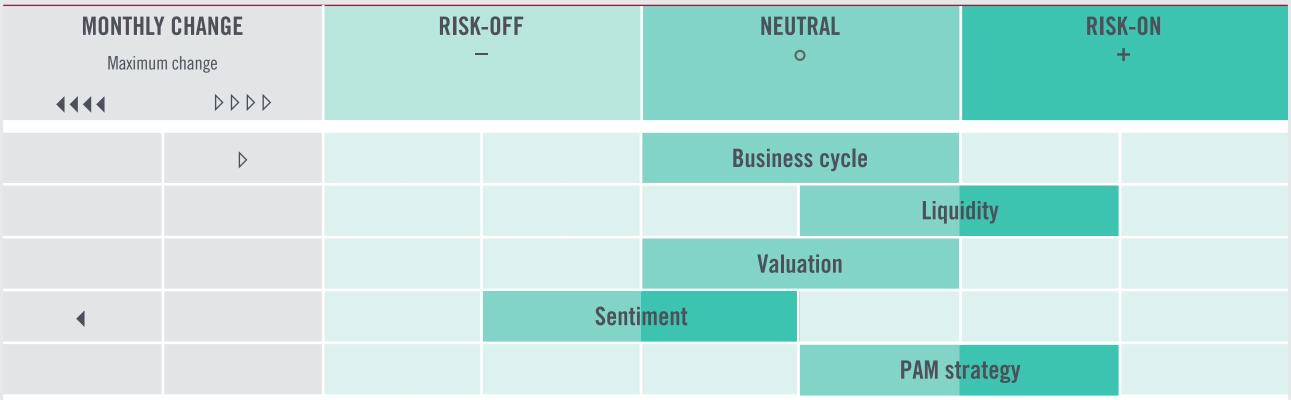


PERFORMANCE: CURRENCIES VS USD



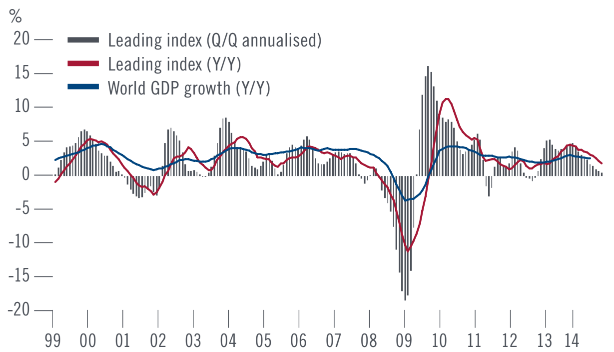
Source: Pictet Asset Management, Thomson Reuters Datastream

RISK BIAS INDICATORS

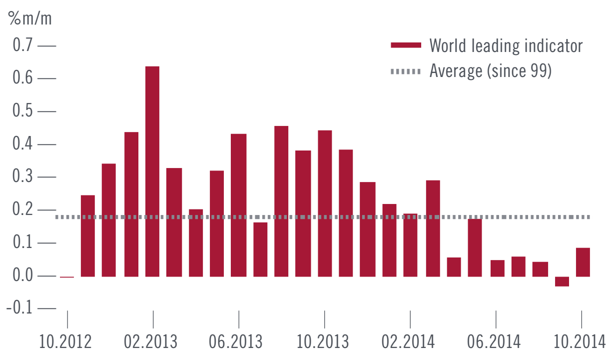


BUSINESS CYCLE: WORLD ECONOMIC GROWTH IMPROVING MODESTLY

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

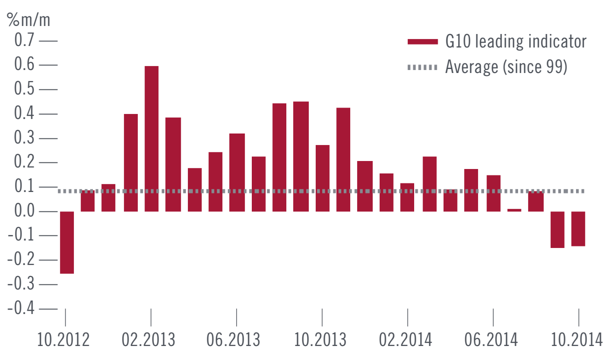


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

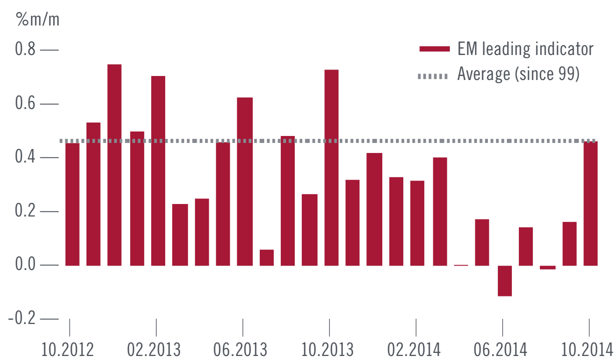


ECONOMIC MOMENTUM PICKING UP IN EMERGING MARKETS

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



Source: Pictet Asset Management, Thomson Reuters Datastream

VALUATION: EQUITY MARKETS AND SECTORS

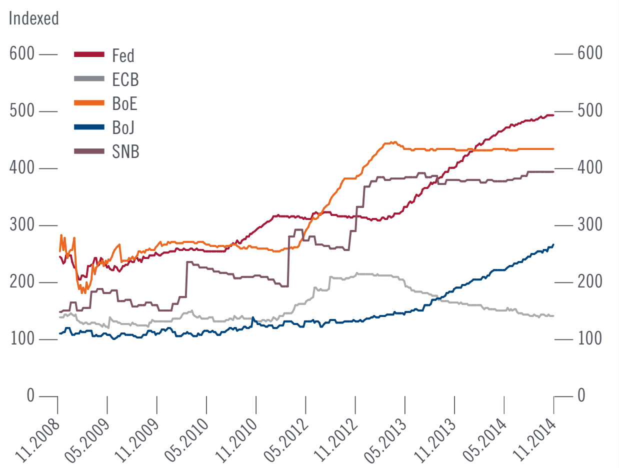
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH 2014	EPS GROWTH 2015	SALES GROWTH 2014	SALES GROWTH 2015	PE 2014	PE 12M	PB 2014E	P/SALES 2014E	DY 2014E
US	8%	10%	4%	4%	17.7	16.2	2.5	1.7	2.0%
Europe	4%	11%	0%	3%	15.5	14.1	1.7	1.1	3.4%
EMU	7%	16%	-1%	3%	15.8	13.7	1.4	0.9	3.3%
Switzerland	0%	10%	2%	4%	18.1	16.6	2.6	2.2	3.0%
UK	0%	4%	0%	1%	14.0	13.5	1.7	1.1	3.8%
Japan	6%	12%	2%	3%	15.9	14.7	1.3	0.7	1.8%
EM	3%	11%	6%	7%	12.2	11.0	1.3	0.7	2.8%
NJA	8%	11%	6%	7%	12.8	11.6	1.4	0.6	2.7%
Global	**5%**	**10%**	**3%**	**4%**	**16.2**	**14.8**	**1.9**	**1.2**	**2.5%**

MSCI GLOBAL SECTORS	EPS GROWTH 2014	EPS GROWTH 2015	SALES GROWTH 2014	SALES GROWTH 2015	PE 2014	PE 12M	PB 2014E	P/SALES 2014E	DY 2014E
Energy	2%	0%	0%	-1%	12.1	12.2	1.3	0.7	3.5%
Materials	1%	13%	0%	4%	15.9	14.1	1.6	0.9	2.9%
Industrials	8%	14%	3%	4%	17.5	15.6	2.3	0.9	2.3%
Consumer Discretionary	-2%	16%	4%	6%	18.3	16.0	2.6	1.1	1.9%
Consumer Staples	2%	8%	2%	5%	20.6	19.0	3.6	1.2	2.7%
Health care	12%	10%	9%	6%	19.4	17.8	3.6	2.0	1.9%
Financials	6%	12%	5%	5%	13.6	12.2	1.2	1.7	3.3%
IT	12%	10%	4%	7%	17.6	15.9	3.0	2.1	1.6%
Telecoms	-2%	6%	2%	3%	16.4	15.6	2.1	1.3	4.1%
Utilities	1%	9%	2%	2%	16.1	15.0	1.5	0.9	3.8%

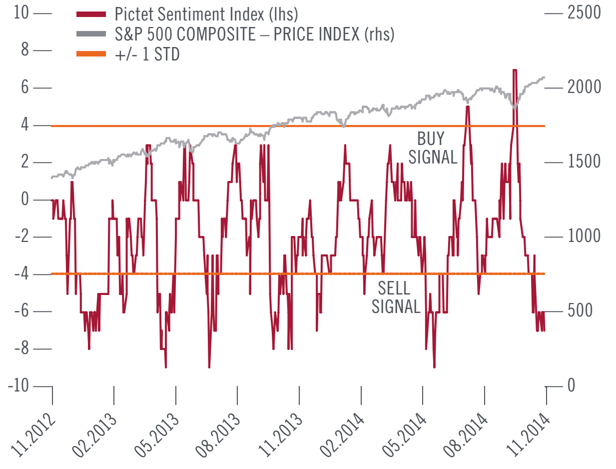
LIQUIDITY: FED ENDS QE BUT MONETARY STIMULUS CONTINUES ELSEWHERE

SIZE OF CENTRAL BANKS' BALANCE SHEETS



US SENTIMENT INDICATOR GIVES BEARISH SIGNAL

PICTET SENTIMENT CYCLE INDEX

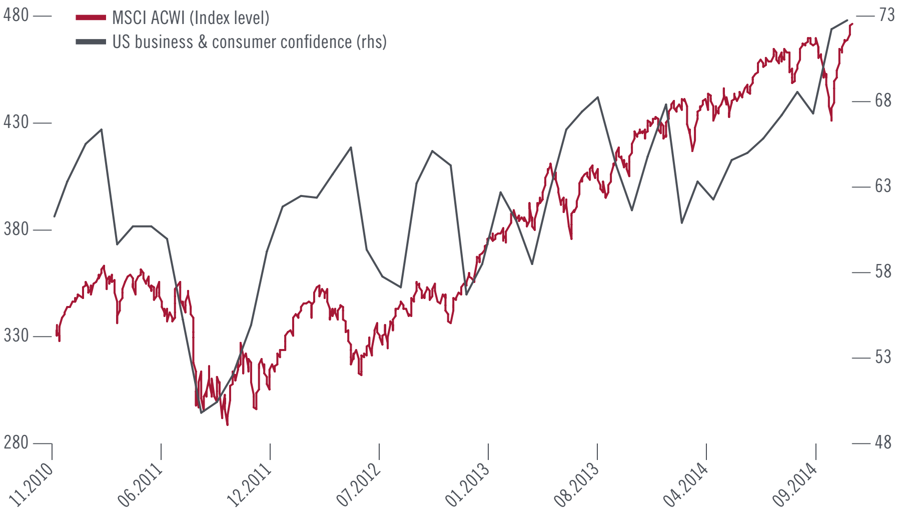


sentiment has improved slightly and the contraction in credit supply is easing. The ECB is under pressure to increase monetary stimulus to boost growth and inflation, which remains well below its 2 per cent target. We expect the ECB to broaden its quantitative easing programme by buying either government or corporate bonds (or both).

Japan may have fallen into recession but the outlook is more promising after the BoJ expanded its monetary stimulus and the government delayed the second round of a sales tax hike to April 2017. Indeed, leading indicators have risen well above the long-term average for the first time since February and retail sales are also improving. We are increasingly optimistic on Japan, and stand ready to increase our allocation once political risks recede after the December general election, which we expect will deliver a fresh four-year mandate to Prime Minister Shinzo Abe and a clear endorsement of his economic revival plan.

China is also making a positive contribution to world growth. Our measure of leading index growth is above the long-term average for the first time since October 2013, thanks to a rebound in construction activity and exports as well as improved consumer spending. The People's Bank of China's interest rate cut may represent the beginning of an easing cycle – we could see two more rate cuts and a reduction in the reserve requirement ratio over the course of next year as the authorities try to boost growth. These measures would help lift other emerging economies, in our view.

GROWTH PICKING UP, BOOSTING STOCKS



Source: Thomson Reuters Datastream

Our **liquidity** readings are mildly positive at a global level, with the euro zone, Japan and China providing the most encouraging signals. In the euro zone, the aggregate supply of money – as measured by M3 - is up 6 per cent on the quarter on an annualised basis.

Liquidity in the euro zone could improve further next year as the ECB aims to expand its balance sheet and private sector lending picks up. Bank lending surveys suggest that both loan demand and credit standard are now improving.

Sentiment signals have deteriorated, indicating a potential market correction, especially in the US and Japan after a rally in November. Investor positioning in US stocks is excessively bullish, according to our readings, increasing the scope for a correction.

The US is also the most expensive region on our **valuation** scorecard, while Japan and emerging markets remain attractive. Valuations are generally high across all major developed stock markets, but this is not unusual during the "late expansion" phase of the economic cycle. Corporate earnings prospects remain lacklustre, as indicated by aggregate profit forecast revisions. These show that earnings upgrades continue to be outnumbered by downgrades in all regions except Japan. That said, equities remain more attractive than bonds.

Equity region and sector allocation

Europe is our top pick; Japan's appeal grows

We continue to favour European stocks from a tactical perspective – it is the only region in which we are overweight even though Japanese equities are also beginning to look attractive.

While the euro zone economy has struggled, we believe the investment climate for European equities should improve as the ECB is becoming ever more aggressive in its bid to avert deflation.

What is more, the positive effects of lower oil prices and a weak EUR should soon feed through to corporate Europe. As long as tensions between Russia and Europe do not escalate, exports from European companies should gather momentum, which should in turn boost corporate earnings. It is worth noting that the third quarter of 2014 delivered a positive surprise on both sales and earnings, suggesting that consensus growth expectations are too pessimistic.

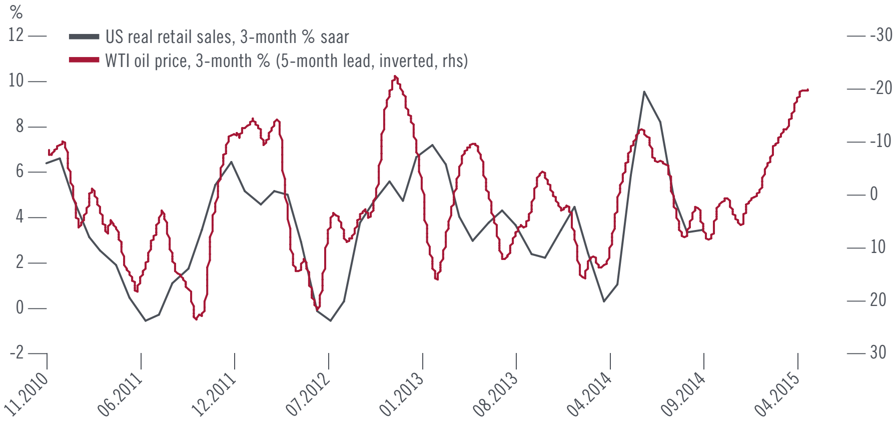
Also, European stock valuations are attractive – the region's equity risk premium is higher than that of any other major stock market (including emerging markets) apart from Japan at around 6 percentage points. Investor positioning in the asset class has also become extremely bearish over the last couple of months following months of investment outflows, raising the scope for a bounce.

Japanese stocks, meanwhile, are attractive on several fronts. First, export-oriented companies stand to benefit from the weak JPY, which is trading below its purchasing power parity rate for the first time. Second, domestic stocks should receive a strong boost from a change in investment policy at Japan's biggest public pension fund, the GPIF, which is to increase its allocation to Japanese equities to 25 per cent from a current target of 12 per cent. Third, the BoJ has expanded its bond purchase programme, which should prove supportive for growth. Lastly, reforms set in motion by Prime Minister Shinzo Abe promise to improve the country's corporate governance. But with a general election looming, we believe the Japanese market is too risky to invest in at this juncture – once the poll is out of the way, we will be sure to reassess our stance.

The US might also appear to be an attractive market – growth is picking up and it is home to a number of large companies that stand to benefit from an oil-inspired rise in consumer spending. Yet, even though US retailers have posted a solid set of quarterly results, US stocks are too expensive on the whole. According to our scorecard, which aggregates a broad range of stock valuation metrics and compares current readings to the historic trend, the US is the most expensive region by some distance.

The main change in our sector allocation is a shift in stance on consumer discretionary stocks from neutral to overweight. Consumer stocks should benefit from a fall in oil prices, as lower energy costs tend to boost household spending. As the chart shows, retail sales tend to rise in the months following a sharp fall in oil prices. US consumers are expected to lead the rise in expenditure although retail spending among European and Japanese households should also increase. We retain our overweight stance on energy – although the fall in oil prices has been steeper than we originally expected, we believe the scope for a further fall is limited, making a cheap energy sector attractive once more. We have reduced our exposure to technology – the sector exhibits strong fundamentals but investor positioning in the sector is excessively bullish.

FALLING OIL PRICES TYPICALLY BOOST CONSUMER SPENDING



Source: Thomson Reuters Datastream

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Fixed Income

Still favour EM debt

We retain our overweight position in emerging market debt, both local currency and USD-denominated bonds. The prospects for local currency debt look especially promising now that China has shifted to a more dovish monetary stance, which should begin to provide support for the asset class. Indeed, we believe China is at the beginning of a rate cut cycle. The yield differential between emerging market local currency and developed government debt – at around 500 basis points – is some 100 basis points above the long-term average.

Valuations aside, monetary policy should also provide some support – we believe a growing number of emerging market central banks will shift to a more accommodative stance in the wake of China's move to underpin its economy.

Emerging market currencies should also begin to recover their poise in the wake of their recent depreciation against the USD. According to our model, emerging currencies are trading some two standard deviations below fair value, an anomaly that we believe will start to disappear over the coming months.

By contrast, valuations for investment-grade European corporate bonds remain too high in our view – we continue to be underweight the asset class. Even though the ECB may yet begin corporate bond purchases as part of its stimulus programme, the market has already discounted this possibility to a large extent, which leaves investment-grade debt vulnerable to a sell-off over the near term. What is more, investment grade debt that has been recently issued has not performed as well as earlier in the year, which could be a testament to a decline in investor appetite for corporate debt.

Certain European government bond markets look even more expensive, particularly compared to their US counterparts. For instance, we believe the yield differential between German Bunds and US Treasuries has grown to an unjustifiably high level. We are therefore positioning for a narrowing of the yield gap by shifting out of German government debt into US treasuries.

When it comes to currencies, we are inclined to wind down our short JPY, long USD position – our readings show that the volume of bearish trades on the JPY is now excessive, indicating recent trends may be about to reverse. We may look to do the same with our short EUR position – investor positioning patterns are similar to those we have seen in the JPY.

Olivier Ginguené, Chairman
Pictet Asset Management Strategy Unit

Luca Paolini, Chief strategist
Pictet Asset Management

CHINESE RATES AND BOND YIELDS FALL

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, historical earnings multiples
- **sentiment:** Pictet sentiment index (investors' surveys, tactical indicators)

BARO1 ANG 1214