Trim equities back to neutral after rebound
- Pictet Asset Management

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"It's time to dial back equities after the rebound" says Luca Paolini, Chief Strategist at Pictet Asset Management.

"February's strong equity rally has given us the opportunity to tactically lock in gains and shift our position to neutral. We expect a number of short term bearish developments to unfold, but believe the medium term outlook for equity markets remains encouraging.

"The near-term outlook for stocks has deteriorated. Economic activity is slowing worldwide, with the US a prominent weak spot. The escalating crisis in Ukraine is another potential source of risk.

"We are planning to visit Russia next week in order to assess the economic and political impact of the events unfolding in the region. That will give us an opportunity to test the validity of our base case scenario: Russia's intervention confined to the Crimean peninsula and the IMF spearheading efforts to avert a financial crisis in Ukraine.

"Should the situation deteriorate and result in heightened tensions between Russia and the European Union, a major casualty could be Europe's economic recovery, which is vulnerable given that the region imports roughly 25 per cent of its gas from Russia, half of which flows through Ukraine. Under this scenario, the EUR would likely weaken sharply against the USD.

"More broadly, with the recent rally in global stocks showing signs of fatigue, the Ukraine crisis could prove the trigger for a market correction.

An escalation of geopolitical tensions may also trigger another sell-off in emerging market assets. This decline may prove contained: not only are emerging market bond and stock valuations attractive but investor positioning in these assets is extremely bearish.

"Any further fall in emerging market bonds, for instance, would in our view increase the investment appeal of the asset class versus developed market government debt.

"Ukraine aside, the recent rally has nevertheless pushed equity valuations to levels that look difficult to justify at a time when corporate earnings forecasts continue to be cut.

"Liquidity conditions are not buoyant enough to provide firm support to riskier asset classes. We are inclined to reduce our stance on oil to underweight but with rising geopolitical tensions in Ukraine clouding the outlook for energy prices, we will remain neutral for the time being. We remain neutral bonds.

"Global economic growth is slowing. The slowdown in the US economy cannot be blamed exclusively on a severe winter. Housing market and consumer spending weaknesses have been evident for some time.

"The picture in emerging markets is more complex. While exports have recovered, China remains something of an unknown quantity as it struggles to balance the task of deflating a credit bubble with meeting its annual growth target of 7.5 per cent.

"Longer-term, the prospects for riskier asset classes look more encouraging. In Japan, we expect the central bank to increase monetary stimulus as soon as the second quarter of this year.

"In the euro zone, further monetary easing should also become a reality. Hence, we are confident that global economic growth will recover in the second half of 2014.

Regionally, we prefer Japanese and emerging market equities over US and European stocks. Emerging market stocks continue to exhibit a favourable risk-return profile. Japanese corporations are raising their earnings forecasts in contrast to global trends.

"The recovery in emerging market bonds and currencies looks justified on many fronts. Outflows from the asset class are also moderating. Because of China and various political risks, we remain wary of raising our exposure to emerging assets.

"We prefer high-yield over investment-grade bonds. Speculative-grade debt continues to trade at a yield premium that offers more than sufficient compensation against the threat of default, which remains low by historical standards.

"We also retain our long duration stance in Europe. Although the prospects for an easing of monetary policy in the euro zone look remote in the very short term, the odds for intervention should shorten as the year progresses. It will not necessarily be the fall in inflation that will force the ECB's hand but rather its failure to restore the flow of credit to Europe's southernmost countries.

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Notes to the Editor

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