PICTET
1805
Asset Management

Annual outlook BAROMETER

The investment landscape in 2016

global asset classes

We believe equities will deliver healthy gains in 2016 thanks to moderate economic growth and additional monetary stimulus.

equity regions and styles

Japan and Europe remain our favoured stock markets; both regions benefit from monetary stimulus and improving economic growth. Emerging markets, undervalued and unloved, could stage a strong recovery.

fixed income and currencies

European government bonds should lag their US counterparts while high-yield and some emerging market bonds could see a strong 2016. The US dollar's appreciation is set to run its course.

the pictet
asset management
strategy unit (psu)

is the investment group
responsible for providing
asset allocation guidance
across stocks, bonds,
cash and commodities.

2016: a year of positive surprises

PICTET AM ECONOMIC GROWTH, INFLATION PROJECTIONS, %, MAJOR REGIONS

	GDP GROWTH		INFLATION	
	2015	2016	2015	2016
US	2.5%	2.8%	0.1%	1.8%
EURO-AREA	1.5%	1.7%	0.1%	1.2%
UK	2.6%	2.4%	0.0%	1.3%
SWITZERLAND	0.8%	1.0%	-1.2%	0.2%
JAPAN	0.8%	1.3%	0.4%	1.0%
CHINA	6.9%	6.7%	1.5%	2.0%
EMERGING MARKETS	3.6%	4.1%	4.4%	4.1%
GLOBAL	**2.6%**	**3.0%**	**1.9%**	**2.6%**

Source: Pictet Asset Management

It would not be difficult to convince investors that 2016 might be another tough year. Emerging markets are spluttering, China's economy is decelerating sharply and the US Federal Reserve looks likely to raise interest rates for the first time in a decade in December. Add to this the fact that valuations for US equities are close to record highs, and the case for lowering exposure to riskier asset classes looks appealing.

But while paying attention to investment risks is usually a shrewd move, adopting an overly cautious stance can be rash. Indeed, it is when the investment climate seems unusually harsh that investors should spend more time focusing on what could go right.

In surveying the financial landscape for 2016, our thinking is increasingly guided by the global economy's capacity to deliver pleasant surprises. And in our view, there are sufficient grounds for optimism.

One bright spot is consumption. There is growing evidence that consumers will increase spending in 2016. In the US, unemployment continues to fall while wages are rising at a 2.5 per cent yearly rate. Spending should also get a boost from a strong housing market. None of this should be reversed by an interest rate hike. It is important to remember that the US is not raising rates because the economy is at a risk of overheating (inflation is still well below target) but rather to serve notice that monetary policy is no longer in "emergency mode". Consequently, interest rate rises will come only very gradually.

The same trend is in evidence in the euro zone, where both consumer confidence indicators and retail sales have been rising for several months. China might also give us reason to be a bit more optimistic next year. To facilitate the country's transition to a more balanced, consumption-oriented economy, policymakers are sure to provide more fiscal and monetary stimulus over the next several months.

The combination of moderate global economic growth and stimulative monetary policy should prove to be beneficial for riskier asset classes, especially those whose valuations are below the historic average. (By our estimates, central banks will inject some USD1 trillion of additional liquidity into the financial system in 2016). We expect European equities and emerging market stocks to deliver the strongest returns in 2016, outpacing the expensive US market by some margin. The outlook for bonds is less clear cut: European government bonds look expensive and their returns should lag those of their US counterparts. In the foreign exchange markets, meanwhile, we expect the US dollar's appreciation to run its course in 2016. Any depreciation in the currency - which our models show is some 30 per cent overvalued - could have positive implications for some emerging market currencies and bonds.

Equities to trump expensive bonds

GLOBAL STOCKS SET TO GAIN FROM LIQUIDITY BOOST
Excess liquidity boosts price-earnings ratio with 6-month lag

Source: Pictet Asset Management, Thomson Reuters Datastream

Economic and financial conditions should prove benign for riskier asset classes in 2016. Global output is likely to expand fast enough to lift corporate profits, but not at a pace that would knock central banks into monetary tightening mode.

True, the Fed may be about to lift interest rates for the first time in 10 years, but that move is unlikely to be followed by a series of rapid-fire hikes given the risks faced by the US economy. This, and the growing likelihood of more monetary stimulus from both the European Central Bank and the People's Bank of China, means that ultra-easy monetary policy will continue to be a key feature of the investment landscape. Equities should therefore do well.

Fixed income asset classes – government bonds in particular – should do less well. Even if several major central banks remain in easing mode, yields on many developed world government bonds are hovering at unjustifiably low levels, not least because inflationary pressures look likely to build as the year progresses.

Our business cycle indicators suggest economic conditions should prove positive for riskier asset classes. Recent manufacturing data such as the global purchasing managers' index indicate demand is picking up, with inventories running down and new orders on the rise. Particularly encouraging is the fact that retail sales worldwide are growing at an annualised 3 per cent rate, offsetting what continues to be disappointing industrial production data. The US should draw support from strong consumer spending and a continued recovery in the housing market. US consumer confidence indicators are at a 10-year high while rental vacancy rates are at their lowest in decades. Still, with US exports more or less flat year-on-year thanks to the strong US dollar, growth should only edge up from 2.5 per cent this year to 2.8 per cent next – not enough to justify an aggressive tightening of monetary policy. Private consumption in Europe has also gained strong momentum. Retail sales across the single currency zone are growing in the region of 2.5 per cent year-on-year.

Business and consumer lending is also gathering momentum. The pace could pick up further in 2016 as the ECB quantitative easing programme – which looks set to expand – is helping boost the availability of household and corporate credit. That the money supply is expanding at 5 per cent per year – the fastest rate since 2009 – is a good sign.

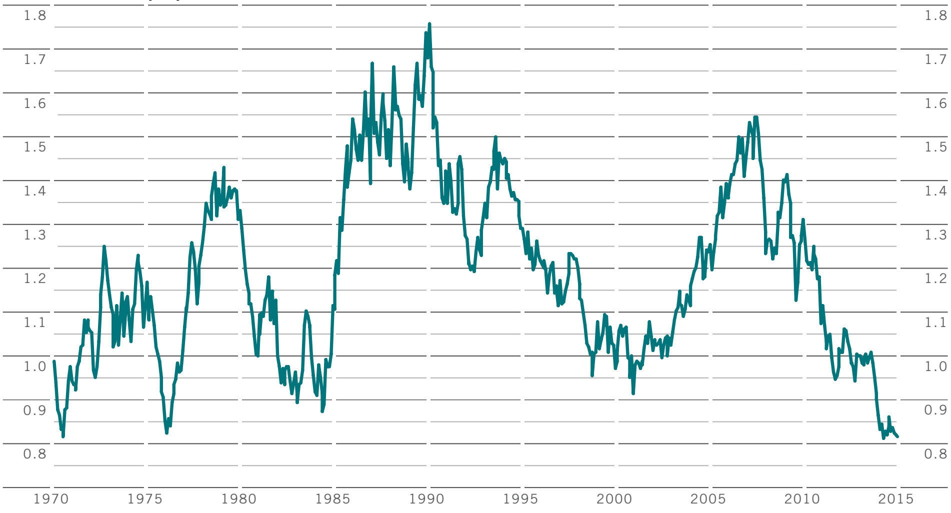
The prospects for emerging markets are improving too, albeit slowly. We expect China's economy to perform better than most economists envisage. Construction activity and property sales look to have bottomed out, the services sector is proving resilient and monetary conditions are easing. Indeed, services (which includes consumer spending) grew at a 12 per cent annual rate in the third quarter, a testament to China's transition to a consumption-led economic model. With Chinese authorities likely to deliver additional fiscal and monetary stimulus in 2016, we are confident the economy can grow at around 6.7 per cent, higher than the consensus forecast of 6.3 per cent. As a consequence, emerging market growth should rise from 3.6 per cent in 2015 to 4.1 per cent.

Our liquidity gauges also suggest investors should increase their exposure to riskier asset classes over 2016. Our analysis shows a strong positive relationship between liquidity and stocks' earnings multiples. Excess liquidity – which we calculate by subtracting the annual rate of industrial production from the rate at which money supply is expanding – tends to widen price-earnings ratios with a six-month time lag. With excess liquidity having risen over most of 2015, this should provide strong support to stocks over the medium term. Europe is where our liquidity readings are strongest. Bank lending to corporations has been rising but remains about 10 per cent below its historic peak, leaving plenty of room for loan-making activity to pick up. In the US, meanwhile, conditions are less benign. Not only is the Fed about to raise rates but the US Federal loan officer survey reports a tightening in corporate lending standards. Indicators for China, meanwhile, are also positive. Our readings show liquidity in China – as measured by M2 money supply – is expanding at its fastest rate since the summer of 2014.

When it comes to valuations, equities remain the most attractive asset class. Ostensibly, stocks are not cheap. A price-earnings ratio of 15.5 for global stocks is in line with the historical average. According to our model, which compares the price-earnings ratio of S&P 500 constituents to bond yields, inflation and trend GDP growth, stocks are above fair value. But relative to bonds, equities are attractive – we estimate that US bond yields would need to rise to 3 per cent to make stocks more expensive than fixed income.

European and emerging stocks to lead the way

EUROPEAN STOCKS ATTRACTIVELY VALUED VS US MARKETS
MSCI Europe performance relative to MSCI US, in US dollars



Source: Thomson Reuters Datastream

As 2015 comes to a close, European and Japanese stocks are among the most attractive in the developed world. Not only are these markets relatively inexpensive, but their prospects are also underpinned by ultra-loose monetary policy and healthy levels of corporate earnings growth. However, the biggest surprise of 2016 could well be emerging market stocks which are both unloved by investors and trade at very cheap levels.

European stocks appear attractively-priced on a number of measures, particularly when compared to their US counterparts. As the chart shows, the MSCI Europe Index is trading at its deepest ever discount to the MSCI US Index in US dollar terms. A similar picture emerges when price-earnings ratios are taken into account. Using the Shiller cyclically-adjusted price earnings ratio, we find that euro zone equities trade at 15 times earnings against 24 times in the US – a 35 per cent discount that is three times greater than the long-term average.

That valuation gap is at odds with the monetary and corporate developments we expect to unfold in the US and Europe over the course of 2016. European stocks will enjoy one big advantage over the US over the next several months: looser monetary conditions. This, in turn, should underpin corporate profitability across the region. As things stand, analyst consensus forecasts suggest corporate profits should rise by some 9 per cent in Europe. What is more, given how cheap European stocks are compared with their US counterparts, the region could see some of its large companies become takeover targets for US firms. This could also help push the market higher over the next 12 months.

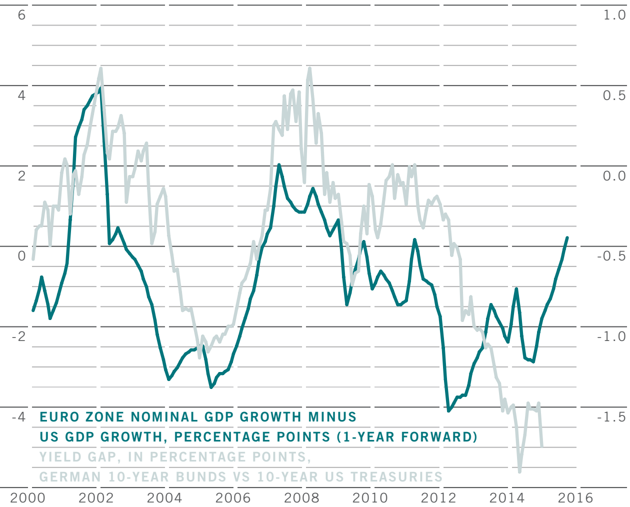
Emerging market stocks are also trading at lowly valuations that look increasingly difficult to justify. Comparing the price-earnings ratios of emerging market and global stocks, developing world equities are trading at 33 per cent discount, the biggest gap since 2006. The differential is an even wider 37 per cent when price-to-book ratios are taken into account, a discount that was last seen in 2003.

With these valuations in mind, and given that we expect the US dollar to eventually depreciate and commodity prices to stabilise, 2016 could witness a strong rebound in emerging market equities. The US dollar's impact on emerging market asset classes should not be underestimated. It has a direct effect on exporting nations, particularly commodity exporters. A weaker US dollar also tends to be associated with an increase in investor appetite for risk. That is an important relationship to bear in mind particularly as investor sentiment towards emerging market stocks is already at exceptionally low levels. Bank of America/Merrill Lynch's Global Fund Manager Survey shows that the net percentage of asset managers that are overweight emerging market stocks is at its most negative since the poll came into existence in 2006. Within emerging markets, we expect Asian stocks to deliver the strongest returns – they trade at a discount of some 15 per cent to their Latin American counterparts compared with a historical premium of 15 per cent. Korean stocks look particularly attractive as the economy would be among the first to benefit from any improvement in world trade. Should the West lift the economic sanctions it has imposed on Russia, Russian stocks may also see a strong recovery.

Elsewhere, Japanese stocks also look set to outpace global equities next year. The weakness in the economy is likely to be temporary. Nominal GDP growth in Japan in the third quarter was actually stronger than that of the US while corporate earnings are growing at a solid 12 per cent clip, better than any other region in the developed world. That trend should continue thanks to the reforms being introduced by the government of Shinzo Abe.

European government bonds to shift into reverse gear

GERMAN BUNDS SET TO LAG US TREASURIES AS US/EURO ZONE GROWTH GAP NARROWS



Source: Bloomberg, Thomson Reuters Datastream

If a panel of judges were tasked with identifying the 'consensus trade of 2015' in fixed income they would probably settle for long German government bonds, short US Treasuries.

As the ECB has embraced quantitative easing and the US has gradually tightened the monetary reins, investors have snapped up German bonds as enthusiastically as they have shed US debt. So violent has this shift been that the yield on the 10-year German Bund now sits some 170 basis below that of its US counterpart, the most negative level since the launch of the euro.

That trend will go into reverse in 2016, in our view. Our research shows that the yield differential between Bunds and Treasuries is heavily influenced by the gap in the nominal growth of the US and euro zone economies.

With that growth gap now almost closed, we believe that the yield gap between German and US government bonds will also narrow over 2016 - even if US and euro zone monetary policies diverge. The influence nominal economic growth has over the Bund/Treasury yield gap operates with a lag of about 12 months, we have found (see chart).

This is not the only consensus trade that will unwind next year. The US dollar's appreciation looks set to give way to depreciation over the next 12 months.

By our calculations, the US dollar's ascent has left the currency trading at levels that are some 25-30 per cent above fair value. Over the past 30 years, it has only ever hit this level three times (late 1984, early 2002 and early 2009). Each time it has done so, it has subsequently embarked on a path of depreciation, losing 10-30 per cent over the following five years.

As we wrote in our Secular Outlook in May this year, we expect the US dollar to depreciate by a cumulative 10-15 per cent through until 2020. That will take the currency back to its long-term equilibrium rate.

A depreciation of the US dollar has positive implications for a number of riskier asset classes, not least emerging market bonds and currencies. According to our model, emerging market currencies are trading close to three standard deviations below their fair value.

The prospect of a currency rebound materially strengthens the investment case for local currency emerging market debt, especially at a time when the asset class offers a yield of 7 per cent. Of all the local currency debt markets in the emerging world, it is Brazil that we find most attractive. With Brazilian bonds now offering a yield of some 15 per cent, we believe the market has already discounted the country's woes, which include weak growth, a spike in inflation and a recent downgrade of its credit rating to non-investment grade status.

Elsewhere, we also believe that US high-yield bonds offer good value. The recent sell-off has taken yield spreads on such debt to levels that offer ample compensation against the risk of default. Default rates, currently running at a yearly 2 to 3 per cent, are below the historical average. Indeed, when factoring in US stocks' lofty valuations, we believe the risk-reward profile of US high yield is now comparable to that of US equity.

RISKS TO OUR BASE-CASE SCENARIO

1 **RATE SHOCK**
A policy mistake – in the form of, for example, overly-aggressive monetary tightening from the Fed – triggers a market crash that tips the economy into recession. In our view, this is unlikely as we believe the Fed will err on the side of caution, preferring to let inflation build rather than stem the economic recovery.

2 **CREDIT SHOCK**
The build-up of foreign currency corporate debt in emerging markets becomes unmanageable due to a continued rise in the US dollar, triggering a credit bust.

3 **GROWTH SPURT**
Consumption growth proves stronger than expected and M&A picks up further, delivering a "breakout" in world growth and leading to a build up in inflationary pressures currency corporate debt in emerging markets becomes unmanageable due to a continued rise in the US dollar, triggering a credit bust.

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Issued November 2015

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)

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