PICTET
1805
Asset Management

	Underweight –		Neutral ○		Overweight +	Monthly change (Maximum change ◄◄◄◄ ▷▷▷▷)
GLOBAL ASSET CLASSES						
Equities			Equities			
Bonds		Bonds				◄
Cash				Cash		▷
Gold				Gold		
Oil			Oil			
USD			USD			
EQUITY REGIONS AND STYLES						
Japan				Japan		
US	US					
Europe					Europe	
Pacific		Pacific				
Emerging			Emerging			
Mid & Small Cap				Mid & Small Cap		
Value			Value			
EQUITY SECTORS						
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						
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			◄

GLOBAL ASSET CLASSES

We remain neutral equities in the lead up to the first US rate hike and cut bonds to underweight on valuation grounds.

EQUITY REGIONS AND STYLES

We keep our preference for Europe and Japan - earnings prospects look most positive in these regions. The US is expensive while emerging markets are not yet a 'buy'.

EQUITY SECTORS

We maintain a moderate tilt towards cyclicals with an overweight stance on information technology and financial stocks - the sectors most likely to benefit once US rates start rising.

FIXED INCOME

We raise local currency emerging market debt to neutral and lower exposure to emerging corporate debt to lock in gains.

Keeping our powder dry ahead of Fed move

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

December 2015

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 30 November 2015

Global market overview

Equities rally loses steam

Global stocks were broadly flat in November as worries over the impact of a likely US interest rate hike and concerns about the health of emerging economies were offset by continued monetary support from central banks elsewhere. Stocks also drew support from buoyant corporate merger and acquisition activity; worldwide, the value of M&A deals rose above USD5 trillion this year, a new record.

Industrial and technology stocks gained the most in November, with materials and utilities the laggards. Year to date, consumer discretionary and technology stocks have generated the strongest returns; energy and materials stocks are down more than 10 per cent.

Optimism that Chinese authorities would support the economy with more monetary and fiscal stimulus helped keep emerging market stocks on an even keel, enabling them to stay some 10 per cent above the lows hit in late August. Cheap valuations appear to be attracting some investors to the asset class.

In fixed income, meanwhile, bonds traded within a narrow range, falling by some 1 per cent in US dollar terms at a global level. Still, European government bonds carved out gains. Two-year bond yields in Germany and France, already below zero, dived deeper into negative territory, reflecting the divergence between US and euro zone monetary policies. The yield spread between 10-year US and German government bonds hit 180 basis points – the widest level in almost 25 years.

In emerging fixed income, bonds fell as a slowing Chinese economy, a US stronger dollar and the prospect of higher US rates weighed on debt issued by countries that rely on external financing.

In the currency markets, the US dollar gained against a basket of major currencies. Sterling also slipped as top Bank of England officials suggested interest rates will be kept lower for longer. Expectations of further monetary stimulus from the European Central Bank weighed on the euro, which lost over 3 per cent against the US dollar to become one of the worst performers in the currency markets this month.

The appreciation of the US unit weighed on oil and other commodities, which were already under pressure from concerns about slowing demand in top consumer China. Commodity prices are now at their lowest levels since mid-2009 (see chart).

COMMODITY PRICES SLUMP TO LOWEST LEVELS SINCE 2009

Source: Bloomberg

Asset allocation

Remain neutral on equities; downgrade bonds

We are keeping our neutral stance on equities as we see no reason to raise risk in our portfolio at a time when both economic activity and corporate profit growth are uninspiring. We have downgraded bonds to a single underweight because we believe the market's inflation expectations are too low. We have also upgraded cash to a single overweight as a buffer against any volatility that could arise ahead of the US Federal Reserve's next rate-setting meeting.

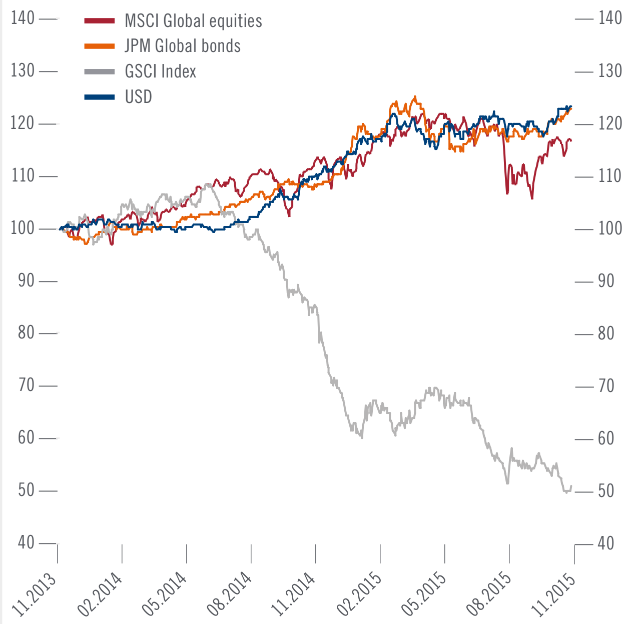
Looking further ahead, however, we think the market could regain its momentum in the coming months.

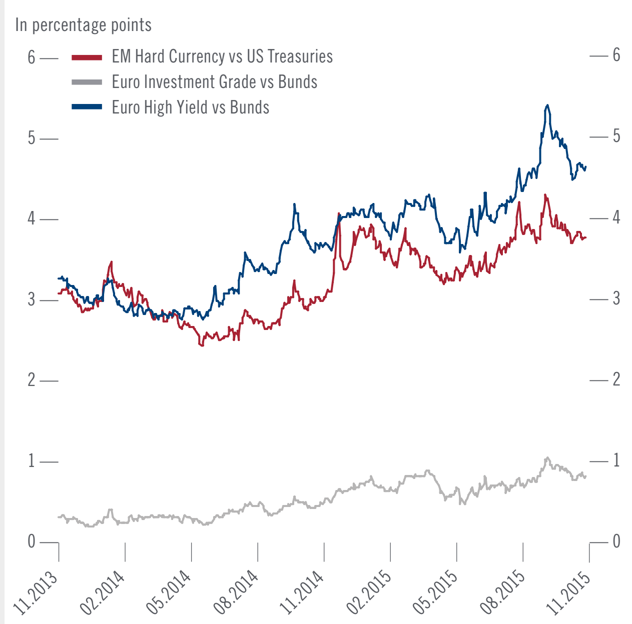
Our **business cycle** readings suggest the developed world's economic momentum remained moderate, with strong consumer spending offset by weak industrial production. In the US, economic growth is showing signs of easing under the strain of a strong US dollar, which is dampening the competitiveness of the country's exports. Industrial production decelerated while surveys indicate manufacturing is also slowing. Housing market momentum also lost pace, though wage growth points to a pick-up in inflation some time in 2016. More positively, retail sales remain resilient. We continue to believe December will see the first move in what will turn out to be a gradual increase in interest rates by the Fed.

In Europe, growth seems on track despite some setbacks. Retail sales have slowed somewhat but remain robust overall. Industrial production momentum has improved while manufacturing activity has eased due to weak external demand. Credit growth remains moderate, but we expect lending to pick up as the ECB stays committed to support the economy and push inflation towards

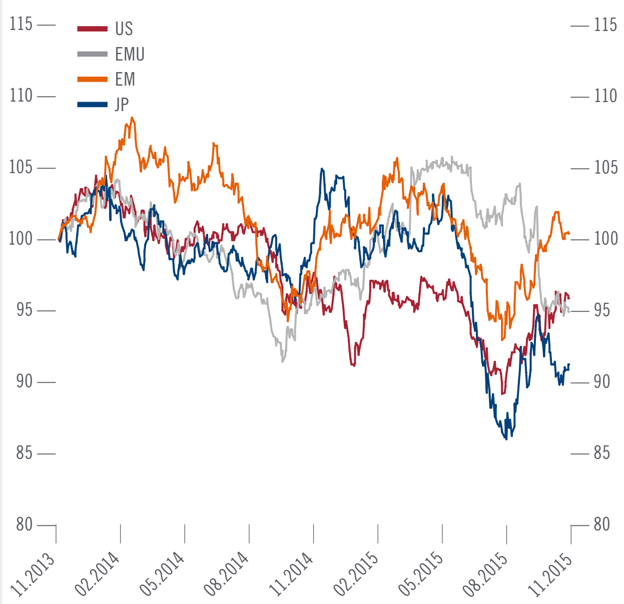
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

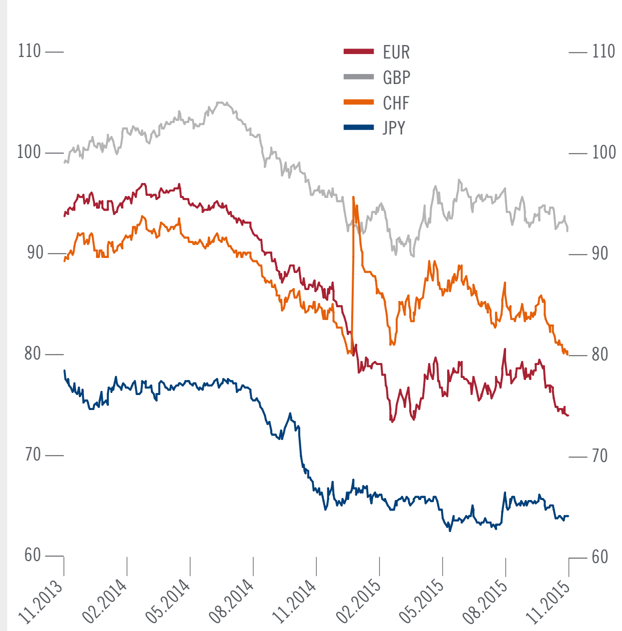
MAJOR ASSET CLASSES





EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE





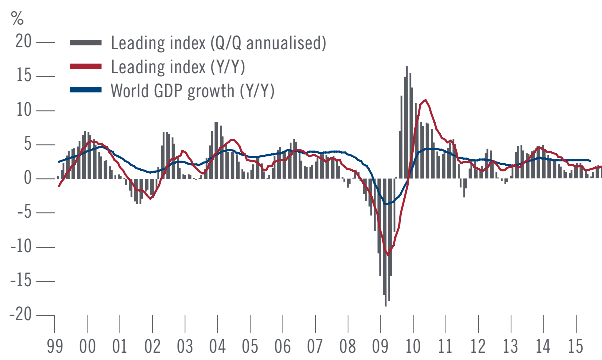
Source: Pictet Asset Management, Thomson Reuters Datastream

RISK BIAS INDICATORS

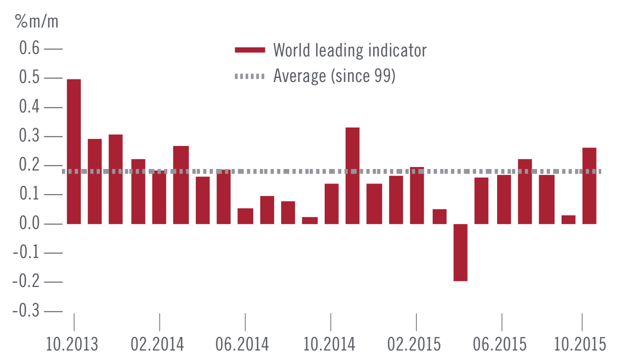
MONTHLY CHANGE Maximum change ◀◀◀◀ ▷▷▷▷		RISK-OFF –		NEUTRAL ○		RISK-ON +	
					Business cycle		
				Liquidity			
◀				Valuation			
◀				Sentiment			
				PAM strategy			

BUSINESS CYCLE: SIGNS OF STABILITY EMERGE

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

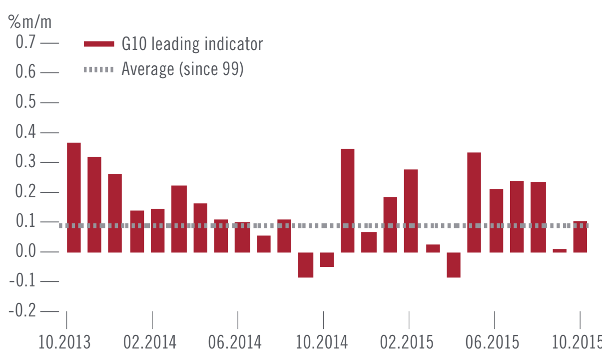


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

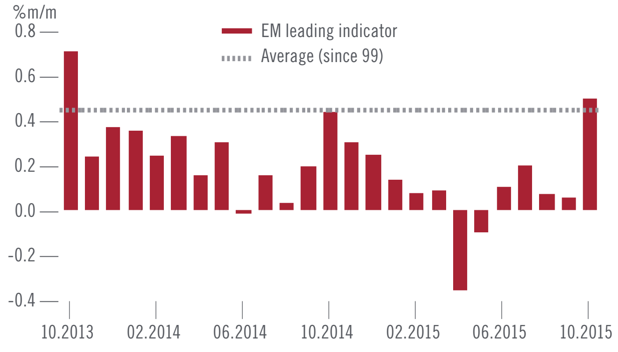


ECONOMIC MOMENTUM MAY BE RECOVERING IN EMERGING MARKETS

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



Source: Pictet Asset Management, Thomson Reuters Datastream

VALUATION: EQUITY MARKETS AND SECTORS

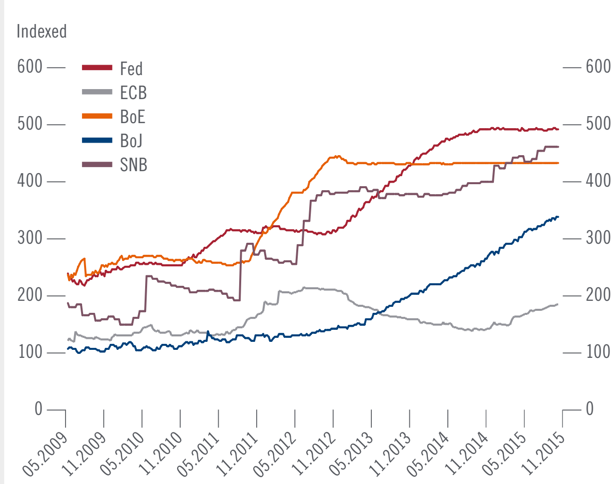
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH 2015	EPS GROWTH 2016	SALES GROWTH 2015	SALES GROWTH 2016	PE 2015	PE 2016	PB 2015E	P/SALES 2015E	DY 2015E
US	1%	8%	-3%	4%	17.8	16.6	2.7	1.9	2.1%
Europe	-1%	7%	-3%	3%	16.0	15.1	1.8	1.2	3.5%
EMU	11%	8%	4%	3%	15.7	14.6	1.6	1.0	3.2%
Switzerland	-6%	5%	-1%	3%	17.8	17.0	2.4	2.3	3.1%
UK	-15%	5%	-13%	2%	15.7	15.1	1.8	1.2	4.2%
Japan	19%	7%	1%	3%	15.4	14.7	1.4	0.9	1.9%
EM	-2%	9%	-1%	7%	12.1	11.2	1.4	0.7	3.0%
NJA	3%	8%	-1%	7%	12.3	11.5	1.3	0.7	2.9%
Global	**0%**	**8%**	**-2%**	**4%**	**16.7**	**15.5**	**2.0**	**1.4**	**2.6%**

MSCI GLOBAL SECTORS	EPS GROWTH 2015	EPS GROWTH 2016	SALES GROWTH 2015	SALES GROWTH 2016	PE 2015	PE 2016	PB 2015E	P/SALES 2015E	DY 2015E
Energy	-50%	5%	-27%	3%	20.0	19.1	1.3	0.8	3.9%
Materials	-17%	11%	-7%	1%	17.1	15.5	1.5	0.9	3.0%
Industrials	3%	9%	1%	4%	17.4	16.2	2.5	1.0	2.3%
Consumer Discretionary	12%	14%	6%	6%	18.7	16.6	2.9	1.2	1.9%
Consumer Staples	-1%	7%	1%	4%	21.9	20.5	4.0	1.3	2.6%
Health care	10%	9%	8%	8%	18.8	17.3	3.9	2.1	1.8%
Financials	11%	6%	5%	5%	12.7	12.0	1.2	1.7	3.2%
IT	5%	8%	3%	4%	17.9	16.5	3.1	2.3	1.6%
Telecoms	8%	6%	4%	4%	15.7	14.9	2.2	1.3	4.2%
Utilities	9%	-3%	-1%	1%	13.8	14.1	1.4	0.9	4.0%
Market	0%	8%	-2%	4%	16.7	15.5	2.0	1.4	2.6%

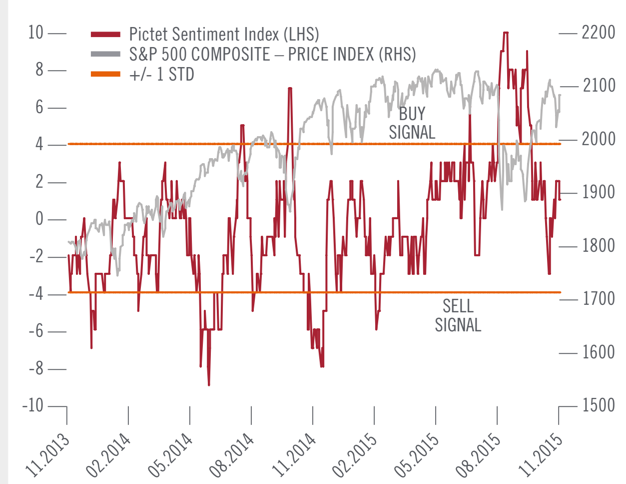
LIQUIDITY: FED ENDS QE BUT MONETARY STIMULUS CONTINUES ELSEWHERE

SIZE OF CENTRAL BANKS' BALANCE SHEETS



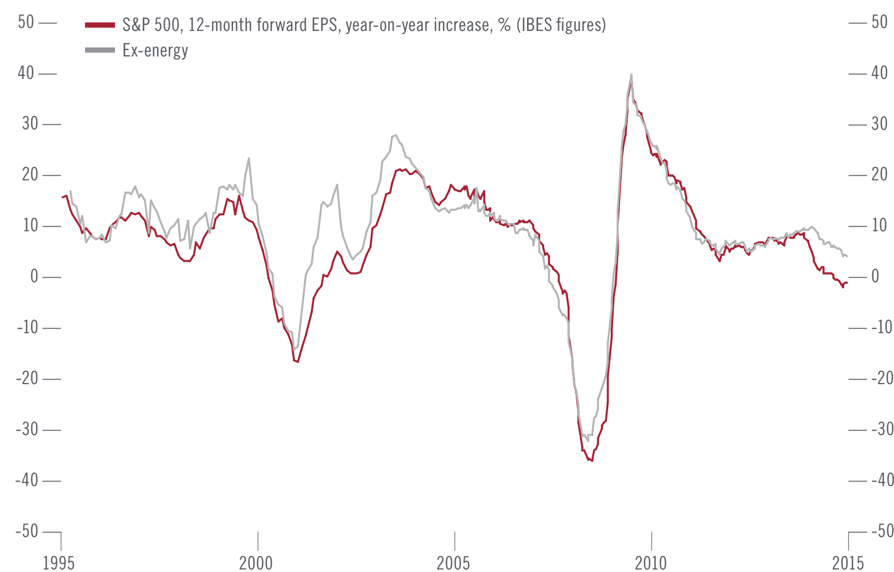
SENTIMENT INDICATOR BACK TO NEUTRAL

PICTET SENTIMENT CYCLE INDEX



US APPEARS TO HAVE ENTERED A PROFITS RECESSION

US earnings per share, year-on-year increase/decrease, %, S&P 500 constituents



Source: Thomson Reuters Datastream

its target. We expect the ECB to extend its quantitative easing programme to March 2017.

Japan entered into a technical recession in the third quarter, dragged down by slow business investment and falling inventories. However, the most recent business and consumer surveys rebounded above their long-term averages and we expect the Bank of Japan to maintain its quantitative easing programme into 2017. Overall we see the Japanese economy recovering, driven by strong domestic spending and higher investment.

Meanwhile, there are signs of stabilisation in China but a concrete recovery in economic activity remains elusive. Strong domestic demand – evidenced by stable retails sales figures – is underpinning growth. There are also signs of improvement in manufacturing though weak exports and industrial production are proving a drag on activity. More monetary policy stimulus is likely. In other emerging markets, there is a growing divide between commodity exporters, battered by weak raw material markets, and manufacturing economies, where there are signs of stabilisation. Our leading indicators show evidence that economic conditions are stabilising following a 13-quarter period in which emerging market growth has remained below potential.

Our **liquidity** readings continue to show a contrast between the US, which is experiencing a withdrawal of money supply, and regions such as Europe and Japan, where credit expansion is gathering pace.

Our central view is that US liquidity will not drain fast enough to offset the buoyant monetary conditions in Europe, Japan and China.

Our **sentiment** indicators suggest taking a neutral stance on equities. The positioning surveys we monitor show investors have turned less bearish, and seem more relaxed about the risk of a hard economic landing in China after Beijing took actions to support the economy.

This upturn in investor sentiment – which we see as limiting the scope for future stock market gains – coincides with technical indicators that flag up similar risks.

Our analysis shows that an ever smaller group of stocks are driving the market higher. With fewer than 50 per cent of global stocks now trading above their 200-day moving average, the probability of a market correction is climbing.

In terms of **valuations**, equities remain less expensive than bonds on the whole.

However, there are some areas where this signal is less powerful. In the US, weak corporate earnings – profits among S&P 500 constituents have fallen in aggregate (see chart) – is becoming a concern.

The US is effectively witnessing a profit recession. As a result, the US equity risk premium – a measure of the expected excess return of equities over risk-free securities – has fallen below its long-term average for the first time since 2008, which means that the valuation advantage stocks enjoy over bonds is lower in the US than it is in other major regions.

Equity region and sector allocation

Prefer Europe and Japan over the US, eyeing emerging markets

In our regional allocation, we keep our preference for equities in Europe and Japan, where central banks are expected to support their economies with more monetary stimulus. Compared to their US counterparts, European stocks appear attractively-valued on a number of measures. Using the Shiller cyclically-adjusted price earnings ratio, we find that euro zone equities trade at 15 times earnings compared with 24 times in the US – a 35 per cent discount that is three times greater than the long-term average. This valuation gap could potentially see many European firms become takeover targets for US companies, which would provide an additional boost to the region's stock market. As the chart shows, M&A volumes are at record highs.

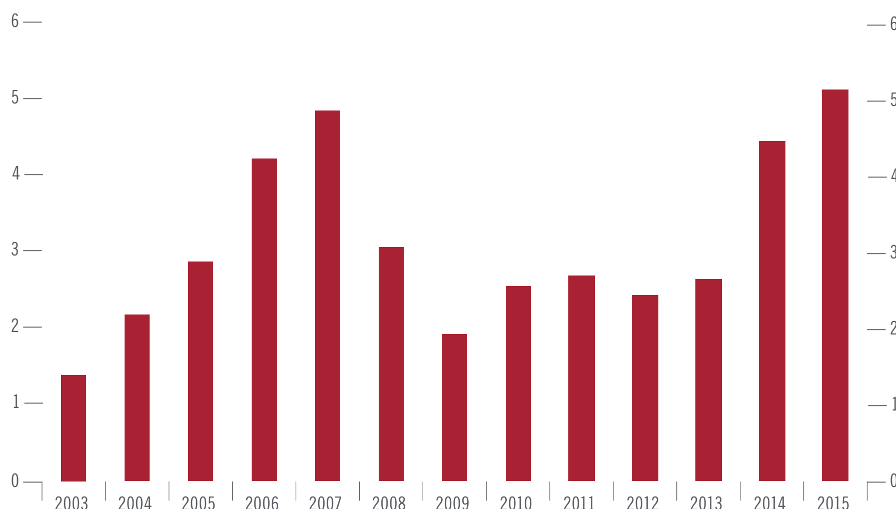
Japan's macroeconomic outlook is also supportive of stocks. While the economy entered into a technical recession in the third quarter, a rebound in export volumes and consumer confidence point to a recovery.

What is more, falling energy prices are not only giving companies more room to raise wages but are also boosting household spending power. The BoJ is likely to maintain its ultra-loose monetary stimulus for some time to achieve its inflation target. We also expect the government to announce some form of fiscal stimulus in the coming months. Also supporting the region's stocks are corporate earnings – with earnings per share among Japanese firms rising at almost 20 per cent year on year, Japan is one of the few major economies that has seen strong profit growth in 2015.

In contrast, a strong US dollar and expectations of an interest rate hike are likely to weigh on stocks in the US, where economic momentum is easing somewhat. On the back of rising yields, the US equity risk premium fell below the long-term average of 4.75 per cent for the first time since 2008, making stocks less attractive versus bonds. We remain neutral on emerging stocks. Recent data suggests the region's economies are stabilising, with leading indicators rising for three months in a row. Additional monetary and fiscal stimulus from Chinese authorities is likely to support growth for the developing world as a whole. However, we need more concrete signs that the Chinese economy has bottomed and the US dollar has peaked before upgrading emerging markets to an overweight.

In our sector allocation, we keep our moderate cyclical tilt with a preference for stocks that are less exposed to rising interest rates. We continue to be overweight technology stocks, whose large cash balances and strong earnings momentum would help them withstand a higher cost of borrowing. Financial stocks are also well placed to benefit from rising US rates and an improvement in European credit conditions. We are still underweight energy and materials. However, their valuations are getting more attractive and we look to upgrade both sectors once we have more positive signs from emerging economies.

EUROPEAN EQUITIES COULD BENEFIT FROM M&A BOOM



Source: Thomson Reuters Datastream

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Fixed Income

Warming to emerging market local currency bonds

Emerging market local currency bonds have had a difficult 2015 but it now seems that the asset class may have seen off the worst of the turbulence. The US's first interest rate hike in some 10 years is unlikely to be followed by an aggressive round of monetary tightening, which means the scene could be set for a recovery in some emerging market currencies.

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. Emerging market currencies – which our models show are trading some three standard deviations below fair value (see chart) – would benefit more than most from a change in the trajectory of the US dollar.

We have positioned for this by scaling back many of our short positions in emerging market currencies and by increasing our exposure to local currency emerging sovereign bonds from underweight to neutral. With the asset class offering a yield of some 7 per cent, valuations are beginning to look attractive. We are gradually building exposure to the markets worst hit by the sell-off – Brazil is one local currency bond market that might soon recover. Its recent woes – rising inflation, weak growth and a credit rating downgrade to junk status – are more than sufficiently discounted in the price of its debt, now yielding some 15 per cent.

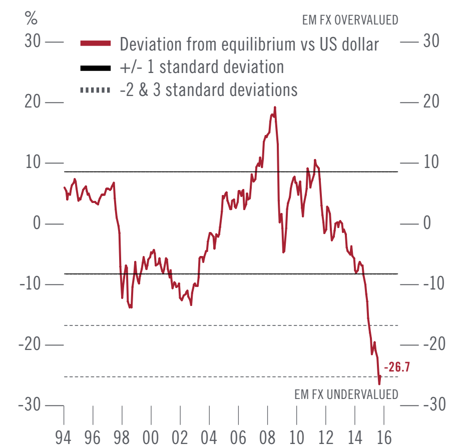
Still, for us to shift our stance to overweight, we would need to have greater clarity on the trajectory of US interest rates as well as evidence of an improvement in emerging market growth.

At the same time, we have cut our exposure to corporate emerging market bonds to neutral. Although we believe developing world corporate bond issuers are not as vulnerable to the strong US dollar as some fear, the healthy returns the asset class has delivered this year have encouraged us to lock in gains. Elsewhere, we remain overweight US and European high-yield bonds. Default rates among issuers of speculative grade debt are low and likely to remain so as the ECB prepares to expand its quantitative easing programme.

Olivier Ginguené, Chairman
Pictet Asset Management Strategy Unit

Luca Paolini, Chief strategist
Pictet Asset Management

EMERGING MARKET CURRENCIES UNDERVALUED



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

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