PICTET 1805

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

GLOBAL ASSET CLASSES
We retain an overweight position in equities as growth is improving and central bank stimulus is abundant; we raise bonds to neutral after the recent fall in Treasuries.

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE
Equities				Equities		
Bonds			Bonds			▷
Cash		Cash				◀
Gold				Gold		
Oil			Oil			
USD			USD			◀

EQUITY REGIONS AND STYLES
We continue to be overweight Japanese and European stocks as corporate earning prospects are improving.

	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
Our cyclical tilt remains in place - in keeping with our positive view on global growth; we cut back our exposure to consumer discretionary stocks and raise IT to neutral.

	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 raise high-yield bonds to overweight as the asset class should benefit from ECB stimulus; valuations are also favourable.

	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			

Stocks have more to offer

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

March 2015

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 2 March 2015

Global market overview

Easy monetary policy, improved economic outlook ignite equity rally

Equities outperformed bonds in February, with world stocks gaining more than 5 per cent and moving towards record highs seen in September. The prospect of additional bond buying from central banks in the euro zone and Japan and broad-based monetary easing in emerging economies supported risky assets. A temporary resolution to the standoff between the new Greek government and the country's creditors over economic reforms also lifted investor spirits.

Cyclical stocks led the equity rally (see chart) as the economic outlook improved at a global level. Technology and consumer discretionary stocks saw the strongest gains while defensive sectors such as utilities lagged by some margin.

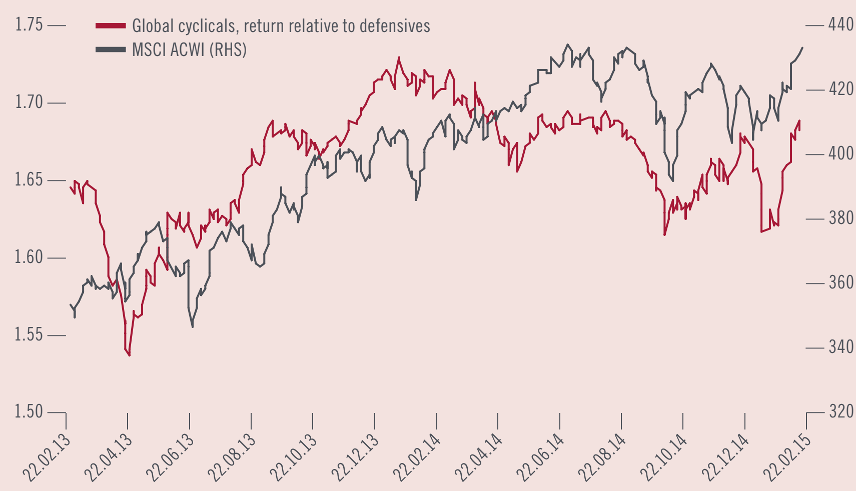
Brent crude rallied more than 20 per cent, recovering some poise after its protracted fall. The oil rally, along with signs that a ceasefire agreement between Ukraine and pro-Russian separatists was holding, buoyed Russian assets, with the RUB seeing a strong rebound and domestic stocks delivering double-digit gains.

In fixed income markets, global bonds ended lower on the month. Government debt underperformed riskier instruments like high yield bonds as a brighter outlook on the global economy encouraged investors to move away from safe-haven assets. US inflation-linked bonds were among the biggest losers as a recent decline in energy prices and falling import prices weighed on the inflation outlook.

In emerging markets, local currency bonds ended lower even though India and Turkey joined other emerging central banks in cutting interest rates to support their economies. Brazilian bonds and the real were the biggest underperformers as the central bank raised interest rates and investors were unsettled by a credit rating downgrade of the state-run oil firm Petrobras.

The USD fell slightly against other major currencies as US Federal Reserve chair Janet Yellen hinted the central bank is in no rush to raise interest rates before mid-year. Gold fell more than 5 per cent to hit a seven-month low as safe-haven demand waned.

CYCLICALS LEAD GLOBAL EQUITY RALLY



Source: Thomson Reuters Datastream

Asset allocation

Risk on stance remains in place; bonds upgraded

We maintain our overweight stance in equities as easy monetary policy from the world's central banks and an improved outlook for the global economy should support riskier asset classes. We upgrade bonds to neutral from an underweight on a tactical basis after US Treasury yields snapped higher last month (see chart on page 6). Our USD stance moves down to neutral as we think the rally in the currency – which has seen it gain 20 per cent in the past nine months - may ease, at least temporarily.

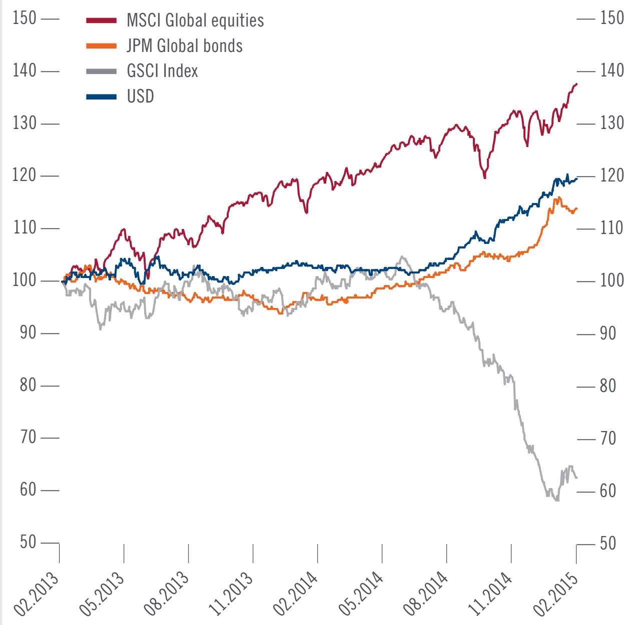
Our **business cycle** readings are positive at a global level, showing clear improvements in the euro zone and Japan, which are the biggest beneficiaries of a recent decline in oil prices. World leading indicators have risen above the long-term average, led by developed economies.

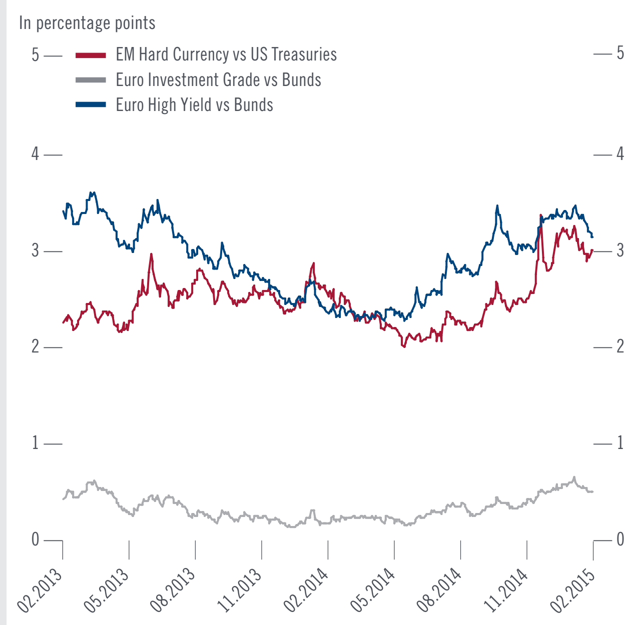
We see temporary weakness in the US economy as manufacturing surveys are pointing to weaker industrial activity and retail sales have undershot forecasts for a second consecutive month. Business spending was particularly weak, with the oil and gas sector leading the slowdown. That said, we still expect the US economy to grow at an annualised 2.8 per cent in the first quarter, above its long-run potential level. US consumers are to increase spending after a decline in energy costs, which should more than offset weakness in business investment. The Fed is expected to raise interest rates in the third quarter as the housing and labour markets improve further.

The euro zone has seen strong improvements, both at a consumer and industrial level. Consumer confidence has hit its highest level

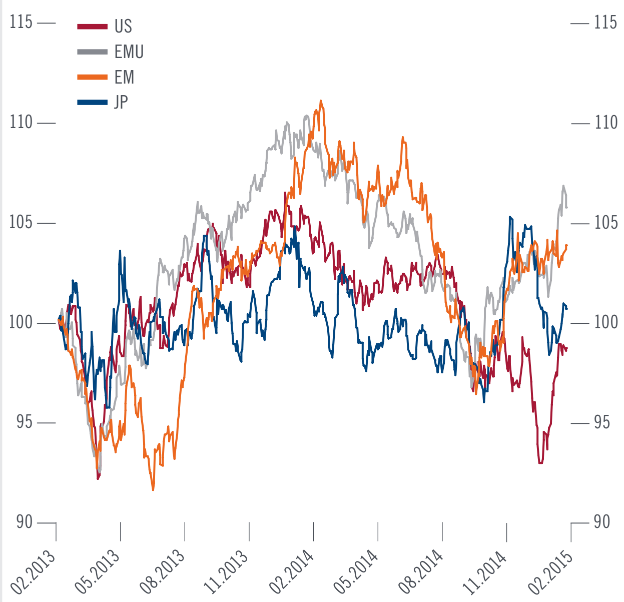
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

MAJOR ASSET CLASSES





EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE



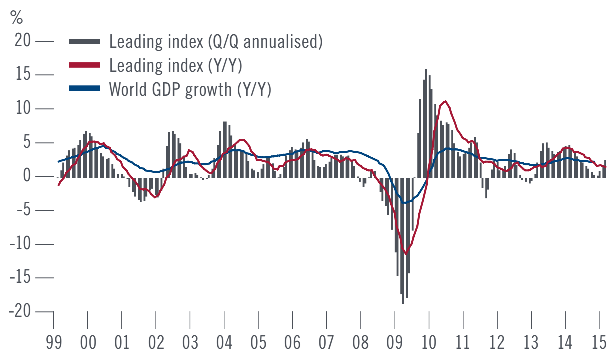
Source: Pictet Asset Management, Thomson Reuters Datastream

RISK BIAS INDICATORS

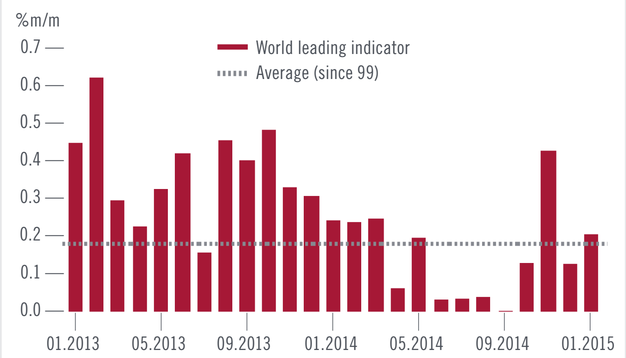
MONTHLY CHANGE Maximum change ◀◀◀◀ ▷▷▷▷		RISK-OFF –		NEUTRAL ○		RISK-ON +	
					Business cycle		
					Liquidity		
◀			Valuation				
◀			Sentiment				
					PAM strategy		

BUSINESS CYCLE: WORLD ECONOMIC GROWTH CONTINUES TO BUILD

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

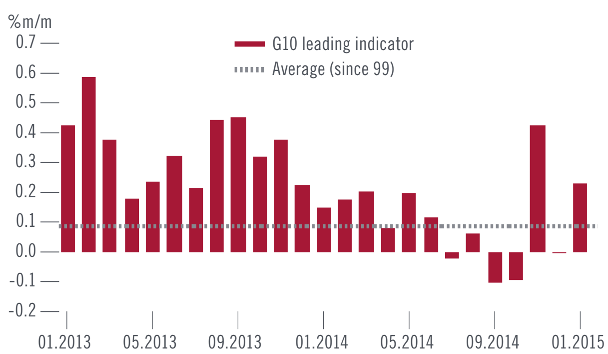


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

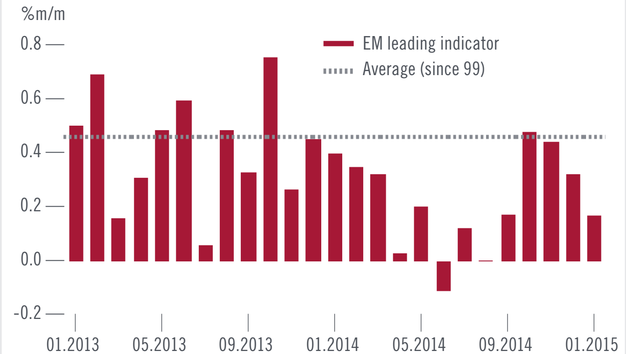


ECONOMIC MOMENTUM REMAINS POSITIVE AT A GLOBAL LEVEL

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



Source: Pictet Asset Management, Thomson Reuters Datastream

VALUATION: EQUITY MARKETS AND SECTORS

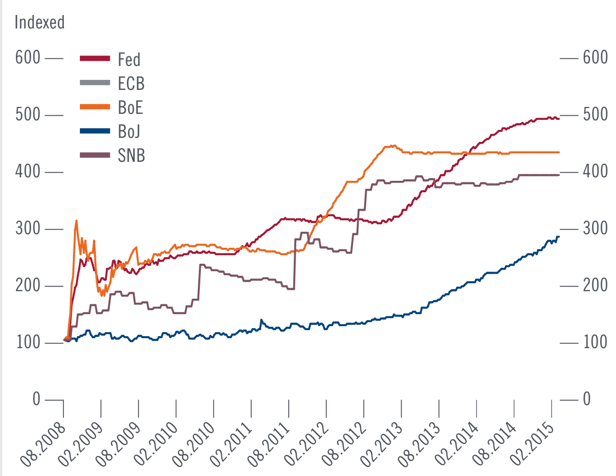
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH 2015	EPS GROWTH 2016	SALES GROWTH 2015	SALES GROWTH 2016	PE 2015	PE 12M	PB 2015E	P/SALES 2015E	DY 2015E
US	2%	13%	0%	6%	17.8	17.3	2.6	1.8	2.0%
Europe	4%	13%	-1%	5%	16.2	15.9	1.8	1.3	3.4%
EMU	15%	13%	2%	4%	15.9	15.5	1.6	1.0	3.1%
Switzerland	-4%	9%	0%	4%	18.1	17.8	2.6	2.4	3.1%
UK	-8%	13%	-7%	8%	15.8	15.4	1.9	1.2	3.9%
Japan	14%	8%	3%	3%	16.8	14.9	1.4	0.8	1.9%
EM	8%	12%	3%	8%	11.9	11.7	1.4	0.7	2.9%
NJA	10%	10%	3%	8%	12.3	12.1	1.4	0.7	2.7%
Global	**4%**	**12%**	**0%**	**6%**	**16.4**	**16.1**	**2.0**	**1.3**	**2.5%**

MSCI GLOBAL SECTORS	EPS GROWTH 2015	EPS GROWTH 2016	SALES GROWTH 2015	SALES GROWTH 2016	PE 2015	PE 12M	PB 2015E	P/SALES 2015E	DY 2015E
Energy	-43%	36%	-19%	11%	20.7	19.6	1.3	0.8	3.6%
Materials	3%	17%	0%	5%	16.4	16.0	1.8	1.0	2.7%
Industrials	12%	10%	3%	4%	16.6	16.3	2.3	1.0	2.3%
Consumer Discretionary	16%	14%	6%	6%	17.2	16.9	2.8	1.2	1.8%
Consumer Staples	2%	10%	5%	5%	20.8	20.3	3.9	1.3	2.6%
Health care	7%	12%	6%	6%	19.2	18.9	3.8	2.2	1.8%
Financials	11%	11%	4%	7%	12.8	12.5	1.2	1.8	3.1%
IT	10%	11%	7%	5%	16.7	16.2	3.2	2.2	1.6%
Telecoms	7%	9%	3%	3%	16.5	16.3	2.3	1.4	4.0%
Utilities	6%	0%	1%	2%	15.1	15.1	1.5	1.0	3.8%

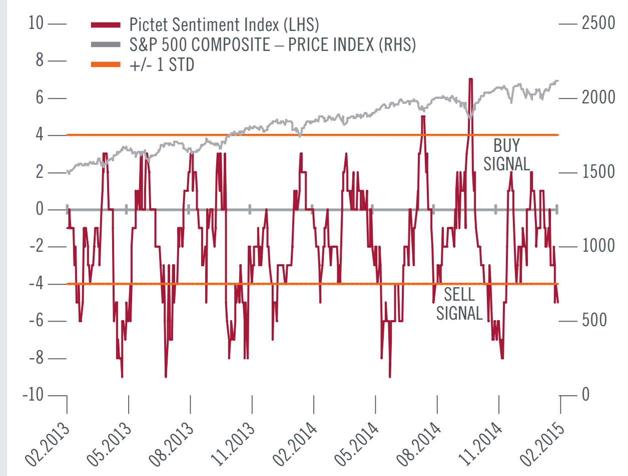
LIQUIDITY: FED ENDS QE BUT MONETARY STIMULUS CONTINUES ELSEWHERE

SIZE OF CENTRAL BANKS' BALANCE SHEETS



SENTIMENT INDICATOR SENDS WARNING SIGNAL

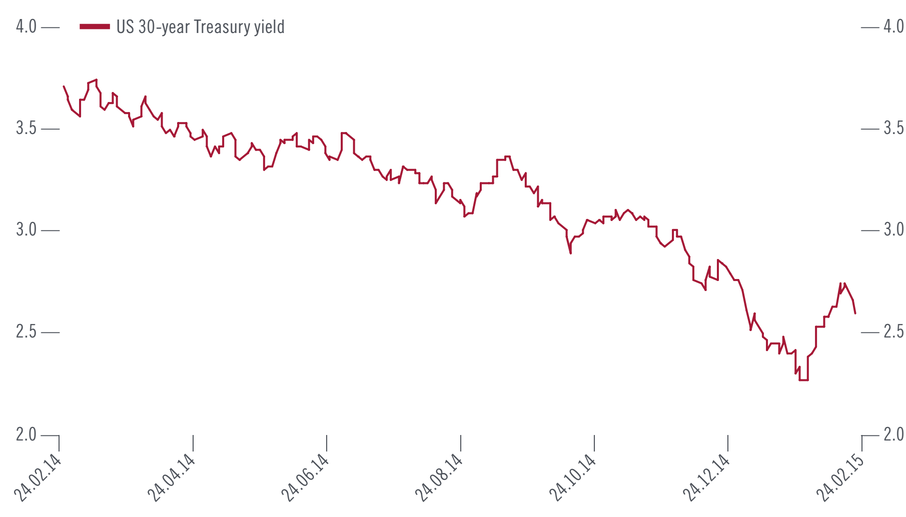
PICTET SENTIMENT CYCLE INDEX



since September 2007, while industrial activity is recovering gradually thanks to rising exports. Credit growth has also rebounded sharply, which we attribute to the completion of euro zone bank stress tests late last year, which removed uncertainty over the financial sector. Lending rates have been falling too, with Spain experiencing a particularly sharp drop of some 50 basis points in private borrowing costs in recent months. Sovereign bond buying from the European Central Bank, which begins in March, should speed up the expansion of credit, contributing to economic growth. What is more, euro zone policymakers agreed to a four-month extension of a financial rescue for Greece, which should remove fears of a funding crunch for the indebted euro zone nation.

Japan's economy is also picking up, with a weaker JPY and improved global demand lifting exports. The country's export volume rose an annualised 24 per cent in the fourth quarter. This should contribute to economic growth this year, which we expect to come in at 1.4 per cent. However, credit and wage growth remain sluggish and inflation stands below the Bank of Japan's target of 2 per cent. We think the central bank may increase the size of its monetary stimulus to push prices higher.

China's overall economic outlook is less clear, and momentum is below the long-term average. Activity in the factory sector hit a four-month high in February, yet property prices declined further. Credit growth is mixed with acceleration in bank lending contrasting with a slowdown in lending in the non-financial sector, where authorities are keen to control financial risks. In response to disinflationary pressures and slowing growth, the People's Bank of China cut interest rates again in March after its surprise monetary policy easing in November.



Source: Thomson Reuters Datastream

More generally in emerging markets, there is an increasing divergence in economic performance between commodity exporters and importers. But many emerging central banks –Indonesia, India and Turkey among them – are cutting interest rates to support growth, and weak EM currencies should also lift exports, particularly as global demand is expected to recover this year.

Our global **liquidity** signals are positive, supported by monetary stimulus from the world's central banks. Euro zone liquidity conditions are expected to improve sharply as the ECB starts its quantitative easing in March, which should help offset any tightening of conditions in the US.

Sentiment readings have turned negative after the recent equity rally pushed some indices to overbought levels, especially in developed markets. But we see no sign of the investor euphoria that typically takes hold in the late market cycle.

V**aluation** indicators are also unfavourable, showing that equities are now at their most expensive since 2004, trading at a 12-month P/E ratio of 16. The fact that earnings forecast upgrades are in short supply, except in Japan, is also a cause for concern. Overall, however, equities are still cheap relative to fixed income. High valuations not unusual at this mature stage of the economic cycle. The US remains the least attractive market for equities.

Equity region and sector allocation

Overweight Europe and Japan, full underweight US

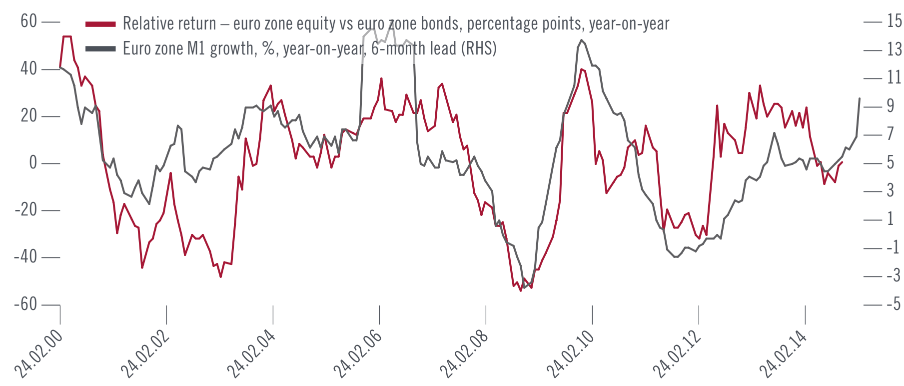
In our regional portfolio, we keep our preference for Europe and Japan over US stocks. This is because we feel these regions offer solid economic and earnings momentum and more favourable liquidity conditions.

There have been signs in recent weeks that economic growth is accelerating in the euro zone, aided by easy monetary policy and a weaker EUR. Recent surveys show that industrial activity rebounded, lifted by better export performance. Household spending is also on the rise as consumer confidence hits its highest since 2007. Notably in Italy, consumer confidence is at levels last seen in 2002. What is more, lending seems to be improving further, with banks more willing to finance and borrowers, both corporations and households, showing higher demand for credit. The ECB's sovereign bond buying programme which is due to start in March will further ease financial conditions in money and bond markets. This improving backdrop creates the conditions for corporate earnings in the region to rise from a very low base. And as the chart shows, euro zone equities tend to fare better than bonds in the six months following a sharp pick up in credit growth.

A similarly positive scenario underpins Japanese equities. The weak JPY has helped exports growth accelerate to the fastest pace in more than a year. The economy is showing signs of a recovery after contracting for two straight quarters. And with inflation still muted nine months after a rise in the national sales tax, the BoJ may decide to expand its QE over the summer, which would be an additional support for the Japanese stock market.

The prospect of a pick-up in growth and profitability has attracted global investment flows to Europe, and to a lesser extent Japan – leaving behind US equity markets where macroeconomic data has been disappointing of late. US company valuations look very expensive when compared with other developed equity markets, and all the more so considering the Fed is preparing to tighten liquidity conditions.

EUROPEAN STOCKS SET TO BENEFIT FROM IMPROVING LIQUIDITY CONDITIONS



Source: Thomson Reuters Datastream

Elsewhere, emerging equities, especially in Asia, exhibit attractive valuations but we do not yet see a clear buy signal. Economic data has been weak across emerging markets recently. The latest figures from China suggest the domestic economy is sluggish and that its once-booming housing market is slowing down, developments which have offset the positive impact of the central bank's recent easing measures. An eventual rise in US interest rates will also act as a short-term drag.

We close our short position in global small caps as valuations have now become more attractive than for large cap companies. A combination of improving global growth and better availability of credit will be supportive.

When it comes to sectors, we continue to prefer cyclical stocks which stand to benefit from the global economic recovery, and those whose valuations are more appealing than defensive stocks. Within our cyclical portfolio, we trim our exposure to consumer discretionary and close our short in technology stocks. Although we still believe consumer stocks will benefit from improving household confidence and greater spending power thanks to lower oil prices and a better labour market, overly-bullish investor positioning puts the sector at risk of a shift in market sentiment, in our view. We are positive on technology stocks which offer solid long-term fundamentals, but investor positioning in the sector appears to be extremely bullish, and this prevents us from increasing our exposure further at this stage.

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Fixed Income

Lifting exposure to high-yield

As the ECB prepares to launch its quantitative easing programme, we have increased our exposure to European high-yield bonds to overweight. The asset class looks appealing on a number of fronts. First, QE will boost the allure of instruments offering attractive single-digit yields. With as many as one in four euro zone government bonds offering negative yields and investment grade bonds yielding barely above 1 per cent, investors looking for income have little choice to but to move into lower-rated credit. Second, economic developments should underpin the credit credentials of issuers of European high-yield bonds. With the euro zone economy likely to grow by some 1.4 per cent according to our calculations, the revenue and earnings prospects of speculative-grade borrowers should remain solid. Third, valuations are attractive – the yield pick-up currently offered by high-yield bonds – they are trading at a spread of around 350 basis points in aggregate – is more than sufficient compensation against the risk of default. The market implied 12-month default rate is approximately 5.7 per cent – more than double the current rate of approximately 2 per cent and above Moody's base-case scenario for 2015 of just above 2 per cent. Encouragingly, flows into high-yield bonds have picked up in recent weeks.

Our positioning in European government bonds, meanwhile, reflects our belief that the euro zone policymakers are at last getting to grips with the problems facing the region. Although Greece's exit from the euro zone is not our base case scenario, the region is better equipped to deal with this outcome than it was a few years ago. It has constructed a robust backstop facility while the ECB's QE programme should offer additional support. Partly for these reasons, we recently closed underweight positions in French and Italian government bonds. It is interesting to note that the very long end of the government bond curve points to a widening of the yield spread between Italian and German sovereign debt. This widening gap is at odds with what we expect to emerge once QE begins. We are also overweight bonds issued by financial companies.

Separately, we have scaled back our exposure to local currency emerging market debt. Growth across the developing world remains patchy: while oil-importing countries have seen their economic prospects brighten, the opposite is true for commodity exporters. This divergence, and the Fed's progression towards interest rate hikes, might serve to increase volatility in emerging currencies even though we regard them as cheap.

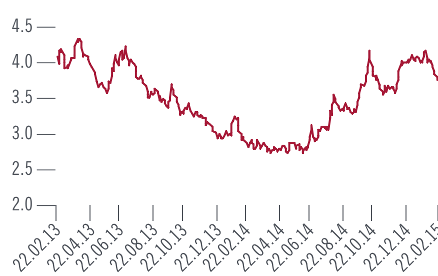
We continue to hold a neutral position in emerging corporate bonds but are mindful of the threat the rising USD poses to the asset class. Corporate bond issuers whose liabilities are largely in USD but whose revenues are primarily in in local currency may come under pressure if the US unit continues its ascent. So far, however, we see few signs of stress.

Olivier Ginguené, Chairman
Pictet Asset Management Strategy Unit

Luca Paolini, Chief strategist
Pictet Asset Management

EUR HIGH YIELD ATTRACTIVE AS SPREADS HAVE RISEN

Spread, basis points, EUR high yield vs 10-year Bunds



Source: BoA Merrill Lynch EUR High Yield Index, Bloomberg

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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