

# Riskier assets find more stable footing

Pictet Asset Management **Strategy Unit**

Monthly euro investor outlook on a 3 month view

# Barometer

October 2015

# Monthly outlook

Pictet Asset Management  
Strategy Unit

Issued 5 October 2015

## Global market overview

### Emerging markets lead decline in global stocks

World equity markets extended their declines in September as investors remained worried that a slowing Chinese economy would weaken global growth. Higher-grade fixed income assets outperformed, however, as investors favoured the safety of debt, with US Treasuries and other top-quality government bonds faring well.

The uncertainty over the timing of the US Federal Reserve's first interest rate hike in nearly a decade also unsettled investors. The US central bank left its monetary policy unchanged on September 17, citing risks to global growth, but left the door open for tightening later this year. It also cut its interest rate forecast for 2016, 2017 and 2018 by 25 basis points in each case. Global equities, which have touched a two-year low (see chart), are on track to have the poorest quarterly performance since 2011. European shares underperformed other developed markets after German carmaker Volkswagen admitted cheating on vehicle emission tests, hitting its shares and those of other car manufacturers. Emerging markets and commodity-related shares were among the worst performers in US dollar terms as fears persisted that China's economic slowdown would curb global appetite for raw materials.

In fixed income, European sovereign bonds were supported by monetary stimulus from the European Central Bank. The German 10-year Bund yield hit a one-month low of around 0.6 per cent after one of the ECB's favoured gauges of market expectations fell to its lowest since February. The euro zone five-year, five-year break-even forward rate, which shows where investors expect 2025 inflation forecasts to be in 2020, fell to 1.58 per cent.

Investment-grade and speculative grade corporate bonds suffered in the wake of the Volkswagen emissions scandal, with spreads on European high-yield bonds increasing to 200 basis points, their widest levels since the beginning of the year.

A downgrade of Brazil's sovereign debt rating to junk status by Standard and Poor's weighed heavily on emerging bond markets. Borrowing costs for emerging markets, measured by the average yield on JP Morgan's benchmark EMBI Global index, rose back above 6 per cent.

In currency markets, the US dollar fell more than 1 per cent against the Japanese yen but rose against many emerging market currencies.

## Asset allocation

### Equities beginning to look better value

The equity market turmoil that started in the late summer has continued into September, with investors concerned about the severity of China's faltering growth and the prospect of tighter US monetary policy.

These worries have some justification: our own indicators show that US and Chinese economic growth is losing momentum and that credit conditions are not as favourable as they were a few months ago. The scandal engulfing Volkswagen brings additional investment risks: should other carmakers come under scrutiny, it could have a negative effect on growth in Germany and other countries dependent on auto sales. The auto sector accounts for about 3 per cent of global GDP; its contribution to world retail sales and industrial output is far higher.

Despite these setbacks, we are not inclined to cut our exposure to stocks – our decision to maintain a neutral stance is a response to attractive valuations and excessively bearish investor positioning. Also, our models show that the 25 basis point reduction in the Fed's forecast for where rates might peak boosts the fair value of the S&P 500 stock index by 5 per cent.

Still, for us to become more positive on stocks in the next few months, we would need stronger 'buy' signals to emerge.

Greater clarity on how monetary policy is evolving in the US is one development that would encourage us to increase exposure to equities, as would a further strengthening of our leading economic indicators for China.

Our **business cycle** readings remain above long term averages in developed markets, suggesting that worries about a loss of momentum in the US are overblown. While consumer confidence readings have eased back and a strong US dollar has negatively affected US exports, household disposable income continues to rise thanks to lower energy

### GLOBAL EQUITIES' CORRECTION CONTINUES

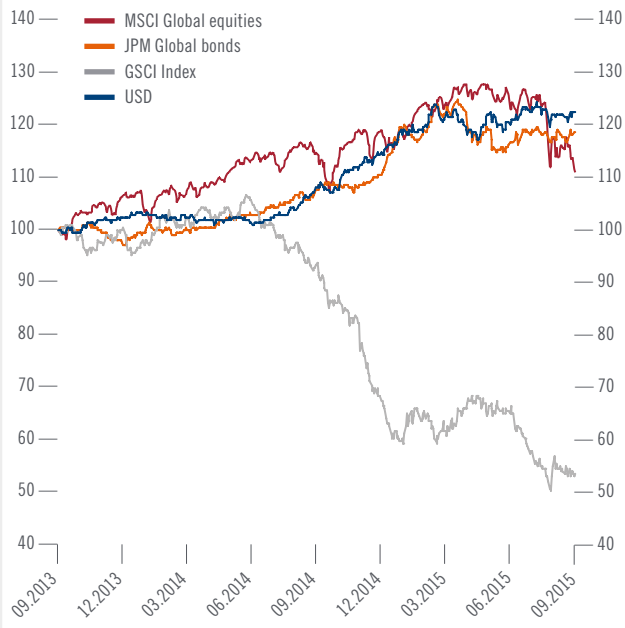
MSCI World (price index, in US dollars)



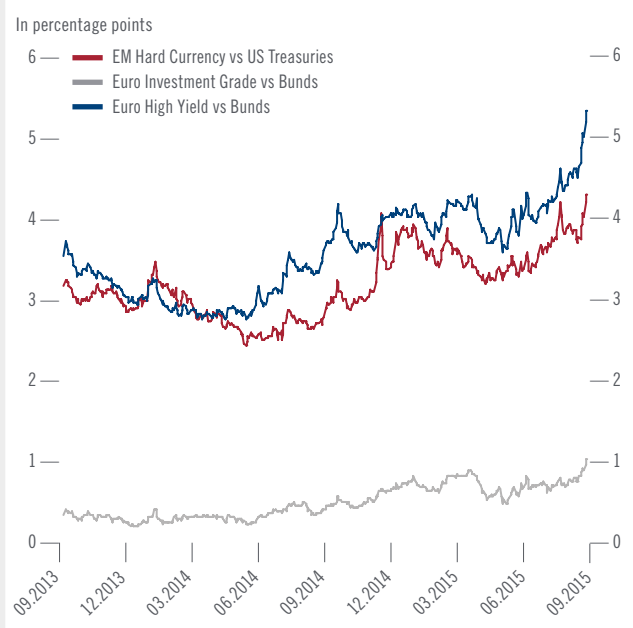
Source: Thomson Reuters Datastream

## MAJOR ASSET CLASSES

PERFORMANCE: ASSET CLASSES

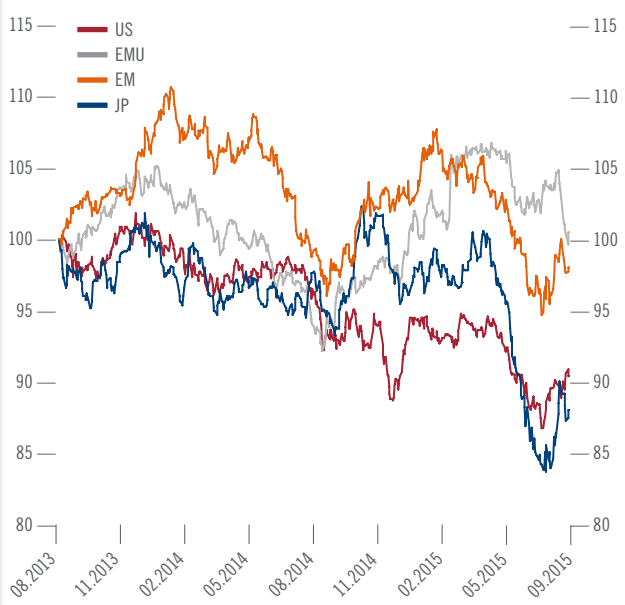


BONDS: ASSET CLASS SPREADS

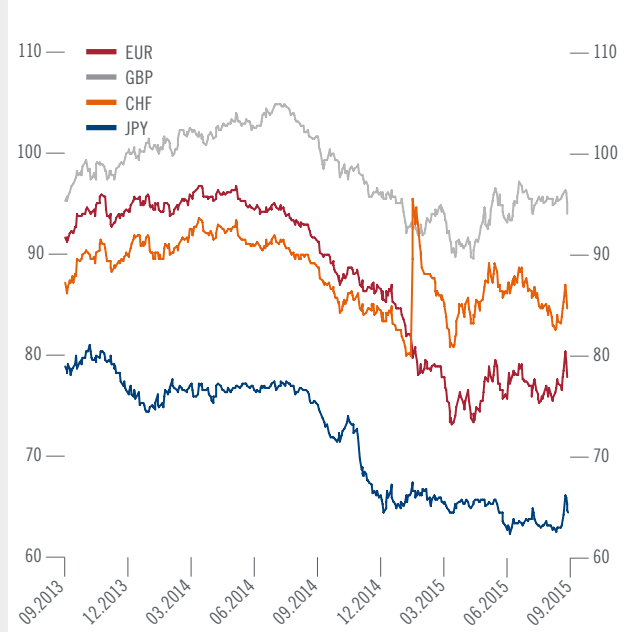


## EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE

GLOBAL EQUITY SECTOR ROTATION:  
PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS



PERFORMANCE: CURRENCIES VS USD

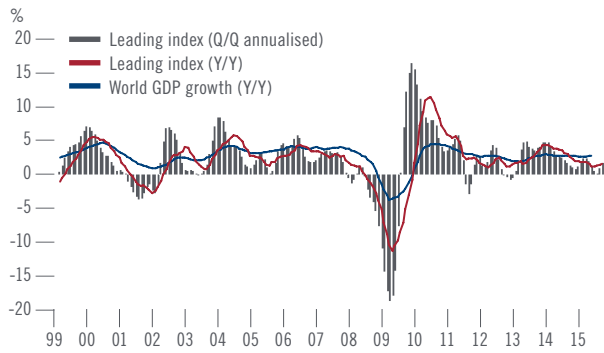


## RISK BIAS INDICATORS

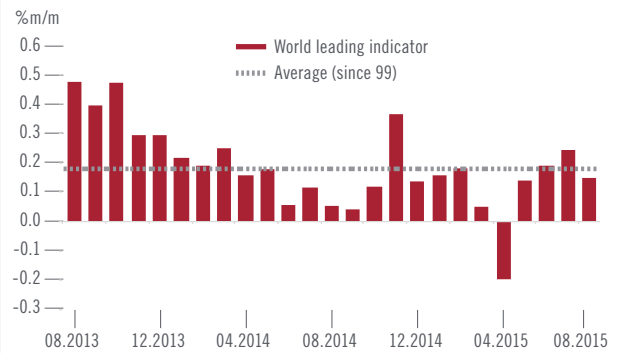
MONTHLY CHANGE Maximum change ◀◀◀◀ ▶▶▶▶		RISK-OFF -	NEUTRAL ○	RISK-ON +
				Business cycle
				Liquidity
	▷			Valuation
	▷			Sentiment
				PAM strategy

## BUSINESS CYCLE: MODEST GLOBAL GROWTH

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

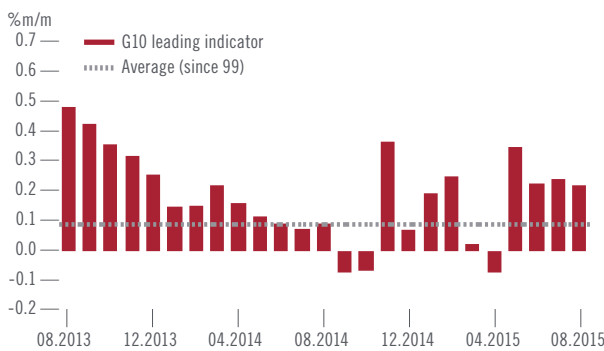


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

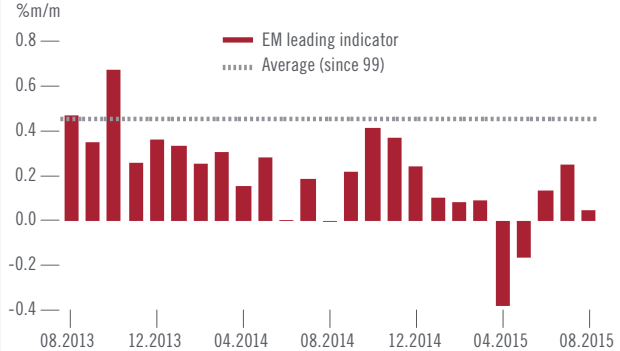


## ECONOMIC MOMENTUM MAY HAVE PEAKED IN DEVELOPED MARKETS

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



## VALUATION: EQUITY MARKETS AND SECTORS

### COUNTRIES AND SECTORS

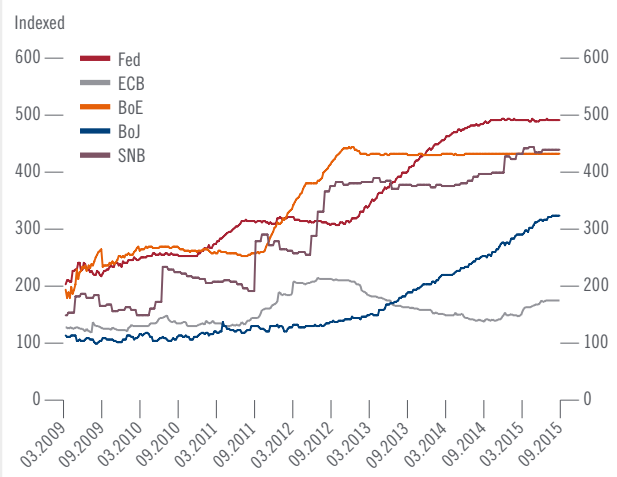
MSCI REGIONS	EPS GROWTH		SALES GROWTH		PE		PB 2015E	P/SALES 2015E	DY 2015E
	2015	2016	2015	2016	2015	2016			
US	1%	10%	-3%	5%	16.1	14.9	2.4	1.7	2.3%
Europe	1%	9%	-1%	4%	14.5	13.7	1.6	1.1	3.8%
EMU	12%	10%	4%	3%	13.9	12.9	1.4	0.9	3.6%
Switzerland	-4%	7%	0%	3%	16.7	15.9	2.3	2.2	3.3%
UK	-13%	7%	-11%	4%	14.5	13.8	1.6	1.1	4.5%
Japan	20%	7%	1%	3%	13.0	12.5	1.2	0.7	2.2%
EM	0%	11%	-1%	8%	11.0	10.2	1.2	0.7	3.2%
NJA	4%	9%	0%	8%	11.2	10.5	1.2	0.7	3.1%
<b>Global</b>	<b>1%</b>	<b>10%</b>	<b>-2%</b>	<b>5%</b>	<b>14.9</b>	<b>13.9</b>	<b>1.8</b>	<b>1.2</b>	<b>2.8%</b>

MSCI GLOBAL SECTORS	EPS GROWTH		SALES GROWTH		PE		PB 2015E	P/SALES 2015E	DY 2015E
	2015	2016	2015	2016	2015	2016			
Materials	-13%	14%	-6%	3%	14.2	13.0	1.3	0.8	3.5%
Industrials	5%	11%	2%	4%	15.2	14.1	2.2	0.9	2.6%
Consumer Discretionary	14%	15%	6%	6%	16.3	14.7	2.6	1.1	2.1%
Consumer Staples	0%	8%	1%	5%	20.0	18.8	3.5	1.2	2.8%
Health care	10%	11%	8%	7%	17.2	15.9	3.5	1.9	2.0%
Financials	12%	8%	6%	5%	11.5	10.9	1.1	1.6	3.4%
IT	6%	10%	4%	4%	15.5	14.4	3.0	2.0	1.8%
Telecoms	8%	7%	4%	4%	14.7	14.0	2.0	1.2	4.5%
Utilities	8%	-2%	-1%	2%	13.5	13.6	1.4	0.9	4.2%
Market	1%	10%	-2%	5%	14.9	13.9	1.8	1.2	2.8%

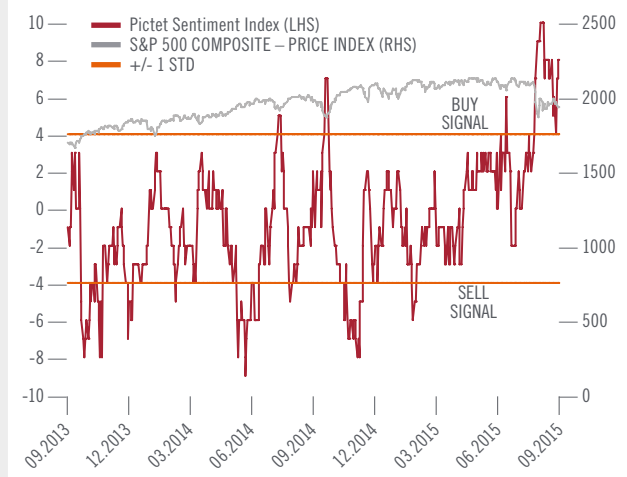
### LIQUIDITY: FED ENDS QE BUT MONETARY STIMULUS CONTINUES ELSEWHERE

#### SIZE OF CENTRAL BANKS' BALANCE SHEETS



### SENTIMENT INDICATOR SENDS BUY SIGNAL

#### PICTET SENTIMENT CYCLE INDEX



bills. Although very recent employment data was softer than expected, the underlying trend in the jobs market is positive with unemployment falling close to 5 per cent and job openings near record levels. The property market is also in good shape.

Europe's recovery, meanwhile, remains on track. The region's manufacturing sector is performing well while consumer confidence is at its highest level since mid-2011.

In the countries of Europe's periphery such as Spain, consumer confidence stands at a 13-year high. We also see evidence of possible acceleration in investment spending. Furthermore, the strength of domestic consumption may prove sufficient to shield the European economy from external shocks emanating from China and elsewhere.

The picture in Japan is more nuanced. Robust domestic spending and a healthy labour market coincide with sluggish exports and weak industrial production.

For emerging markets, however, indicators remain weak; a severe slowdown appears to be taking hold in many key economies. Still, there

are signs of stabilisation. While China is grappling with a decline in external demand and the need to pare back public investment, industrial production, construction and consumption are heading in the right direction. China's purchasing manager's index rose last month – the first time it has registered a monthly increase since March.

This modest rebound could gather more momentum if emerging market central banks follow the example set by India and Taiwan, which cut rates to shore up growth.

Our analysis shows that real interest rates have risen by about 200 basis points among the emerging world's manufacturing hubs in recent months.

A very gradual tightening of global **liquidity** has continued into September which could hamper any market recovery in the near term. Although the Fed has shifted to a slightly less hawkish stance in recent weeks and now looks unlikely to raise rates this year, it is sticking with its stated aim to tighten monetary policy and has also steadily drained liquidity via its money market operations. Credit growth in both the business and household sector is also

easing up from the very high levels seen last year. In China, monetary indicators give mixed signals - the significant capital outflows from the country are reducing available liquidity but money supply and credit growth are rising; what is more, additional monetary easing from the People's Bank of China can be expected in the coming months.

In contrast, European and Japanese policy makers continue to pump liquidity into their economies, offsetting some, but not all of the tightening in US monetary conditions. Signs of a pickup in bank lending, particularly in Europe, give us some cause for to be optimistic.

When it comes to market sentiment, investors have moved to withdraw money from equities and corporate bonds while surveys show investors are in bearish mood. Only 27 per cent of US advisors are bullish – there have only been three occasions in the past 30 years when the bullish component has been lower. Overall, our proprietary sentiment indicator suggests the equity sell-off might soon end.

We believe that **valuations** are attractive for equities after a second month of market weakness with many indices well off peaks achieved earlier in the year. Valuations for global stocks – as measured by 12-month price-earnings ratios – have remained at around 14, a level previously seen in late 2013. In addition, our own composite stock valuation model – which compares the current price-to-book ratio and the equity risk premium of stocks to the historic trend – now gives a positive signal. We estimate that even if US corporate earnings fall 14 per cent from their current level, an event typically associated with a recession, US equities will be still be cheaper than bonds. The gap between stocks' earnings yields and bond yields is hovering at 6 per cent - which is higher than it was in the years prior to 2008 (see chart).

## EQUITIES ARE BETTER VALUE THAN BONDS

Stocks' earnings yield minus bond yield, per cent (MSCI ACWI, JPMorgan GBI Index)



Source: Thomson Reuters Datastream

## Equity region and sector allocation

### Japan, Europe still offer the best prospects

European and Japanese equities remain our favoured markets, partly on valuation grounds but also because corporate profits appear set to grow faster in these regions than in other areas of the world.

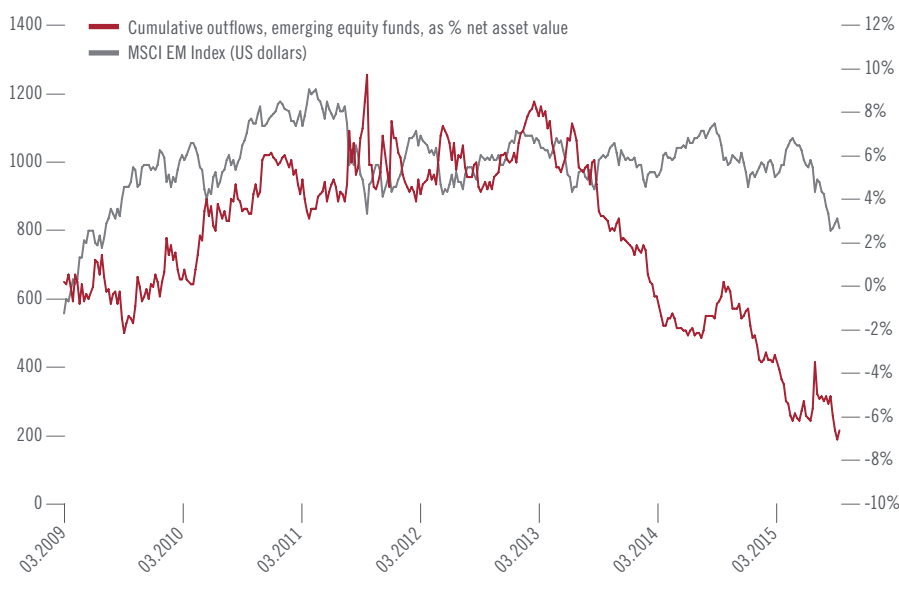
European stocks look particularly attractive. Company earnings are currently rising at an annualised rate in the low single digits but the pace could quicken for a number of reasons. The first is a supportive central bank. The ECB's ultra-loose monetary policy has translated into a burst of consumer spending, shielding the region's companies from China's slowdown and helping the euro zone economy grow for nine quarters in a row.

Also helping corporate Europe is the combination of a weak euro and low oil prices, which should have a positive effect on profit margins. Corporate profit margins in Europe are more or less in line with the long-term average which, when seen in the light of a recovering economy, suggests there is plenty of scope for them to expand. This is in contrast with the situation in the US, where margins are at record levels. Overall, our model suggests that continental European corporate profits should rise at about 10 per cent over the next 12 months, led by financial companies.

Valuations for European stocks also look reasonable. On measures such as price-earnings and price-to-book ratios, European equities trade at a 10 per cent discount to both their US and global counterparts.

Japanese stocks are another bright spot. Much like their European peers, Japanese companies have benefited from a currency-fuelled improvement in their global competitiveness, and a weak yen should continue to be a feature of the financial landscape given the Bank of Japan's ultra-loose monetary policy. At the same time, thanks to

OUTFLOWS IN EMERGING MARKET EQUITY FUNDS REACHING INFLECTION POINT?



Source: Thomson Reuters Datastream

improvements in corporate governance, companies are making more efficient use of their balance sheets, which holds out the prospect for a steady increase in the market's return on equity. Corporate profit margins are also on the rise. None of these developments appear to be reflected in the valuations for Japanese stocks which, on a price-earnings basis, trade at an 8 per cent discount to the MSCI World Index.

We have become a little less pessimistic on the outlook for emerging market (EM) equity, and upgrade the asset class to neutral from underweight. Our decision is based on favourable technical factors. Investors have cut back their holdings in EM stocks to such an extent that the scope for a further fall in the market now appears limited. True, corporate earnings prospects are uncertain, and will remain so until the Chinese economy finds a more stable footing. Yet we believe the market correction looks to have gone too far,

and expect to see investors rebuild positions soon.

Separately, we have cut back our exposure to US stocks. Amid the recent sell-off in global equities, the US market has fared better than most other regions. It is now by some distance the most expensive region on our scorecard. This, coupled with signs of a moderation in US credit growth, suggests the market could lag others should global equities recover.

When it comes to our sector allocation, we continue to be more exposed to cyclical stocks, which trade at a 5 per cent discount to defensive sectors.\*

Technology stocks look especially attractive – their cash-heavy balances leave them well positioned to withstand any rise in US interest rates. Moreover, should US capital expenditure pick up, it is the tech sector that should reap most of the benefits.

\*This discount takes into account long-term earnings growth trends for each sector



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**Fixed Income**

**High yield due a rise**

Fixed income markets have had a testing few weeks as an unusually large number of high-profile corporate and government borrowers have seen their creditworthiness come under scrutiny. The scandals engulfing Petrobras and Volkswagen, Glencore's vulnerability to the commodity market rout and Brazil's credit rating downgrade have contributed to a considerable widening in the yield spreads of both investment and speculative-grade debt. The prospect of heavy corporate and sovereign bond supply is also acting as a weight upon the market.

Euro zone high-yield bonds are now trading at a spread that is some 200 basis points wider than levels seen at the beginning of the year. We are not overly concerned by this correction, however, and maintain our overweight stance on the asset class. One reason for holding our exposure steady is that, with speculative grade bonds now yielding about 6 per cent, they offer more than sufficient compensation against the risk of default. As the chart shows, although yield spreads have risen to their highest levels since early 2013 – the forecast default rate among non-investment grade borrowers has remained stable at near historic lows. And with the European economy building momentum and the ECB set to keep borrowing costs low, there is nothing to suggest default rates will spike over the near term. What is more, a yield of this magnitude means high-yield bond investors would be better protected from the negative effects of

any rise in US interest rates than holders of investment-grade debt.

Another positive to draw from the recent shifts in the high-yield market is the nature of the sell-off itself. In contrast to previous bouts of volatility, this sell-off has not been accompanied by a surge in outflows from high-yield bond funds. Neither has it been indiscriminate – the dispersion of returns among individual bonds has increased as spreads have widened. In other words, the sell-off lacks conviction, which means it could prove short lived.

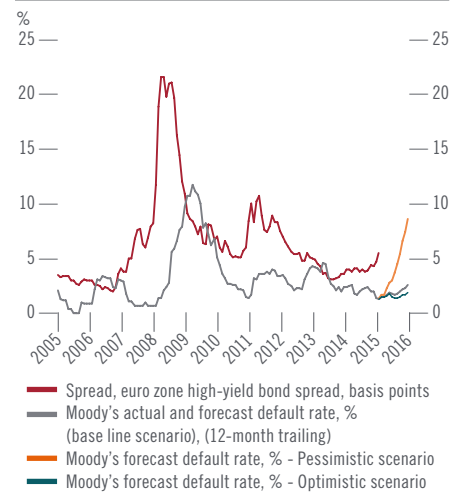
Elsewhere, we remain underweight local currency emerging market bonds. Some developing world economies whose real interest rates look too high appear set to ease monetary policy in the coming months – following in India and Taiwan's footsteps – which we believe could further erode yield support for a number of emerging market currencies against the US dollar. We however maintain our overweight stance on US dollar-denominated emerging market debt as we believe a number of sovereign bonds have been unjustifiably tainted by Brazil's credit rating downgrade.

Separately, we expect the US dollar to lose momentum against a number of developed world currencies. We see the Japanese yen, the euro and the Australian dollar as having the strongest appreciation potential.

*Olivier Ginguené, Chairman  
Pictet Asset Management Strategy Unit*

*Luca Paolini, Chief strategist  
Pictet Asset Management*

**HIGH YIELD BONDS OFFER ATTRACTIVE COMPENSATION AGAINST DEFAULT RISK**



Source: Moody's, 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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