Europe upgraded as the economy begins to turn the corner, Luca Paolini – Pictet Asset Management

Die Pictet-Gruppe | 4. Februar 2015

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Frankfurt / London, 4. Februar 2015

Luca Paolini, chief strategist at Pictet Asset Management, outlines the latest asset allocation changes.

"We have raised our European equity to an overweight from neutral and cut the US to a full underweight. Emerging markets are maintained at benchmark weight.

"European equities are upgraded to reflect the region's increased economic momentum, improving liquidity conditions and favourable valuations, as adjusted over the business cycle.

"The economic picture has been gradually improving in Europe, thanks to the combined effect of a weaker EUR and lower oil prices. Manufacturing surveys point to stronger activity and private consumption has also been on the rise. For the first time in nine months, the economic surprise index – which tracks the extent to which data surpasses or undershoots consensus forecasts – has turned positive. An adverse outcome to the debt negotiations between Greece and its credits remains a risk but we expect the discussions to eventually deliver a compromise.

"Liquidity conditions are also supportive. The ECB's expansion of its asset purchase programme to government bonds unveiled on 22 January went further than many had thought. But its timing is also crucial – the ECB's lending surveys show banks are more willing to lend and that private borrowers are keen to take on debt.

"Valuations for European stocks do not look especially compelling in absolute terms. However, on a cyclically-adjusted basis, the discount at which they trade against their US counterparts remains wide by historical standards. According to Shiller's price-earnings ratios, European equities trade at a record discount of some 33 per cent versus US stocks. This is due to the fact that earnings in Europe are some 30 per cent below their 2008 peak, an unusually low level that is unlikely to persist. Earnings momentum has improved in the region, and our forecast is for some 15 per cent earnings growth for 2015, which looks achievable, particularly in light of the boost to exporters from the lower EUR. Moreover, in USD terms, European indices trade at a record low relative to the US.

"The US market looks more vulnerable. The region's stocks are the most richly valued on our scorecard, and this poses risks, particularly as the Fed is about to raise interest rates. The earnings season has been lacklustre and the strong dollar could start to bite into US companies' margins.

"Japan remains attractive from a valuation and liquidity perspective. The region's stocks look especially appealing from a price-to-book and or price-to-sales perspective (1.3 and 0.7, respectively) and the central bank could face pressure to ease monetary conditions if inflation pressures continue to ease. We retain our neutral view on emerging equities. Extremely heap currencies and an improving global growth outlook are supportive for EM equities, but concerns about liquidity conditions in China prevent us from turning more positive."

Notes to the Editor

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