

September 2016

# BAROMETER

Shaking off  
the Brexit blues

## GLOBAL ASSET CLASSES

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We keep our overweight stance in global stocks as world economic growth is picking up.

## EQUITY REGIONS AND STYLES

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We remain overweight Japan, where stocks are attractively valued, and retain our overweight stance on emerging market equities.

## EQUITY SECTORS

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We remain attracted to cyclical stocks, which should do well as growth accelerates.

## FIXED INCOME

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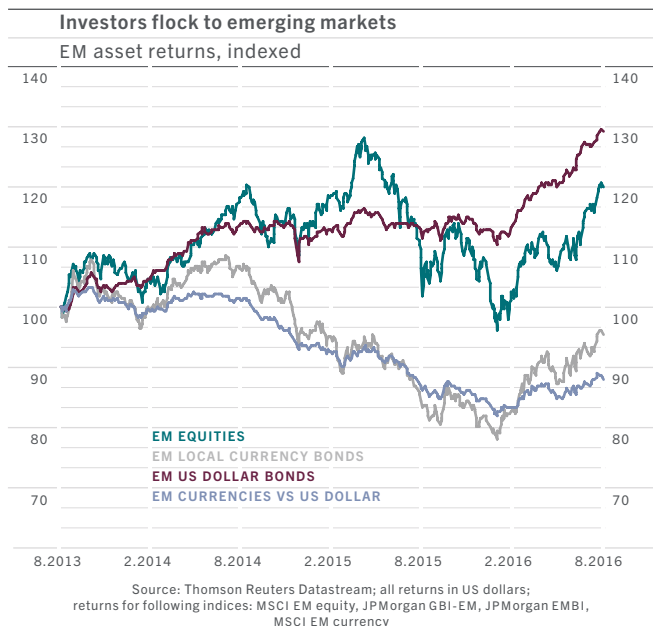
We remain underweight government bonds but retain an overweight position in high-yield debt.

	UNDERWEIGHT —	NEUTRAL 0	OVERWEIGHT +	MONTHLY CHANGE	
				<<<<	>>>>
<b>ASSET CLASSES</b>			Equities		
	Bonds				
<b>EQUITIES</b>		Cash			
		US			
		Euro			
		Swiss			
			UK		
			Japan		
			Emerging markets		
<b>GLOBAL INDUSTRY SECTORS</b>		Pacific ex-Japan			
		Energy			
		Materials			
			Industrials		
			Consumer disc		
	Consumer staples				
		Health care			
		Financials			
			IT		
	Utilities				
			Telecoms		
<b>GOVERNMENT BONDS</b>			US		
	Euro				
	Japan				
	Swiss				
	UK				
		EMD local			
		EMD USD			
<b>CREDIT</b>		US IG			
		Euro IG			
			US high yield		
			Euro high yield		
		Emerging corporate			
<b>CURRENCIES VS. USD</b>		Euro			
		Sterling			
		Swiss franc			
	Japanese yen				
			Gold		

THE PICTET  
ASSET MANAGEMENT  
STRATEGY UNIT (PSU)

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

## Stocks cast aside Brexit concerns



**A**ugust was another strong month for equities as they responded positively to the combination of a more optimistic outlook for global growth, encouraging corporate earnings and a benign monetary backdrop.

Concerned about the economic impact of the Brexit referendum, the Bank of England cut interest rates and restarted its asset purchase programme, while the European Central Bank made clear it would provide more stimulus as and when needed. Meanwhile, the US Federal Reserve stuck to its policy of not scaring the horses despite signs of a pick-up in inflationary pressures and a robust labour market.

Global equities gained ground during the month, with the UK a standout performer among developed markets, up around 1.5 per cent in US dollar terms, while European and Japanese equities also ended higher. But emerging markets outshone all with a near 3 per cent gain on the month, taking their cumulative total return for the year to about 15 per cent.

In light of a strong rally in oil prices during the month, energy was the best-performing global equity sector. Utilities and health care stocks lost ground, with the latter burdened by concerns about political risk ahead of the US presidential election.

In fixed income, while global bonds notched up modest gains, they underperformed equities. Their sluggishness suggests that, with USD13 trillion of government debt already trading at negative yields, the returns that can be expected from monetary stimulus will likely diminish in future.

Still, government bonds' year-to-date return of nearly 12 per cent in US dollar terms outstrips that of equities. For the second month in a row, UK government bonds were top performers in the developed sovereign debt market, gaining some 2 per cent. Both local currency and US dollar-denominated emerging market debt continued to perform strongly, though after gains of nearly 16 per cent and more than 14 per cent respectively so far this year, the scope for further gains seems limited.

Both investment grade and high yield corporate debt had another solid month. European issues performed particularly well thanks to central bank purchases of such securities.

In foreign exchange markets, sterling largely stabilised against the US dollar after the Brexit vote triggered a slump the previous month, leaving the currency down more than 10 per cent in the year to date. Meanwhile, gold weakened marginally during August as expectations for a December Fed rate hike started to firm, though it remains up some 25 per cent year-to-date.

## Equities retain their allure as growth picks up, central banks keep stimulus rolling



The UK's shock vote to leave the EU already appears to be a distant memory. The MSCI Europe equity index is virtually back to the level seen just before the June 23 referendum while its US counterpart has breached its pre-Brexit mark by more than 5 per cent. That could be taken as a sign of investor complacency, but we believe the market's upward move is not only justified, but should continue into the Autumn. Encouraging developments abound.

Economic conditions are improving in many parts of both the developed and developing world while central banks appear ready to do everything in their power to contain risks to growth. What

is more, corporate earnings are gathering strength, even in emerging markets.

That's not to say there aren't clouds on the horizon. We are worried that China's economic recovery might soon lose steam while the UK's looming divorce from the EU is bound to unsettle markets at some point due to the complexity of the negotiations that await the British government.

Even so, we don't expect China or Brexit to emerge as threats in the very near term. We therefore maintain our overweight stance on equities and our underweight position in bonds.

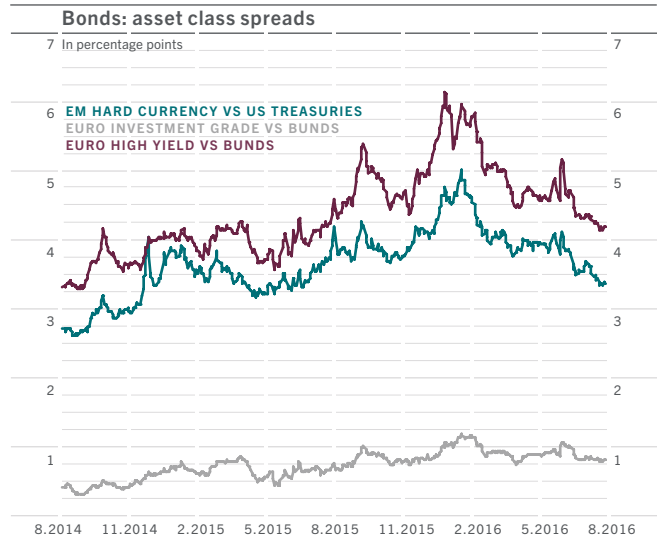
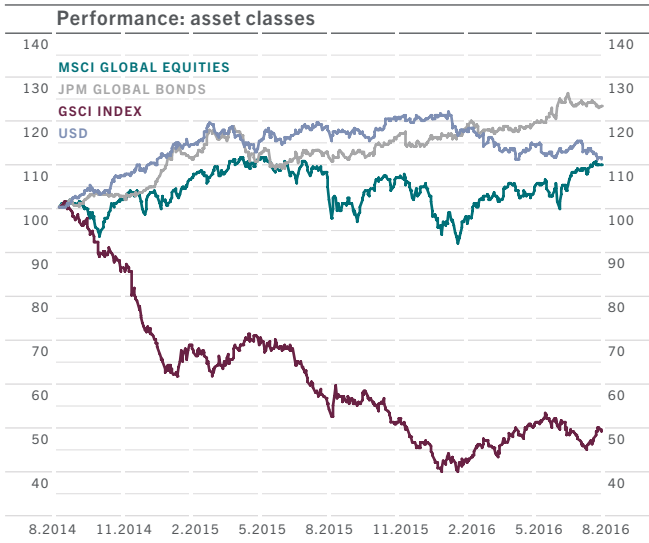
Our **BUSINESS CYCLE** indicators suggest the global economy is firmly in expansion mode. Our proprietary leading indicator has risen to its highest level since February 2014, paced by emerging markets, which have registered their most rapid expansion in almost three years.

Even though the US economy's second quarter expansion was sub-par, the signs are that it is on course to bounce

back strongly in the second half of this year. Our analysis indicates that private consumption should remain a powerful source of growth, fuelled by rising wages. At the same time, other gauges we monitor show that business investment has been improving steadily for four consecutive months. Looking ahead, we expect the economy to register growth of some 3.5 per cent in the third and fourth quarters, which should enable the Fed to raise interest rates by 25 basis points in December.

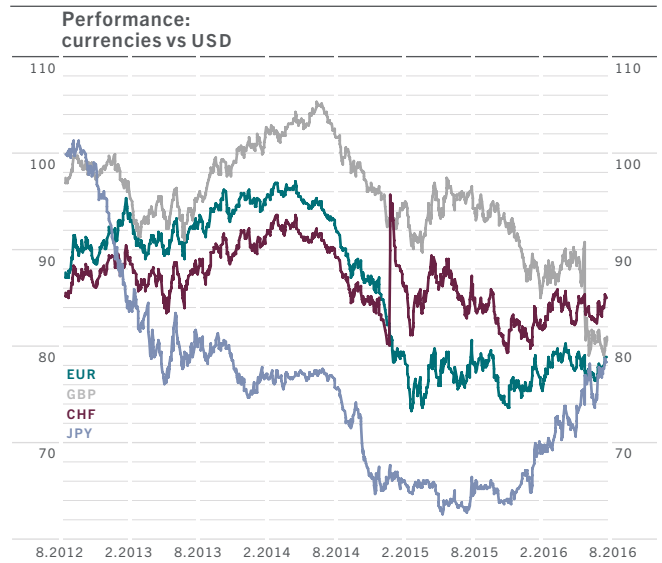
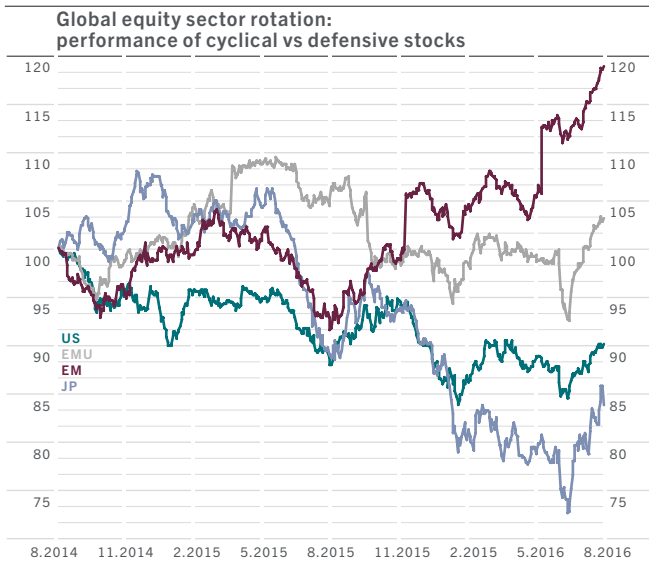
The euro zone is experiencing a similar pick-up in business activity, in an apparent defiance of Brexit. The region's purchasing manager index rose for the second month in a row to 53.3, boosted by services, providing evidence that the ECB's monetary stimulus is beginning to have the desired effect.

### Major asset classes



BAROMETER  
SEPTEMBER 2016

### Equity sector rotation and currency performance

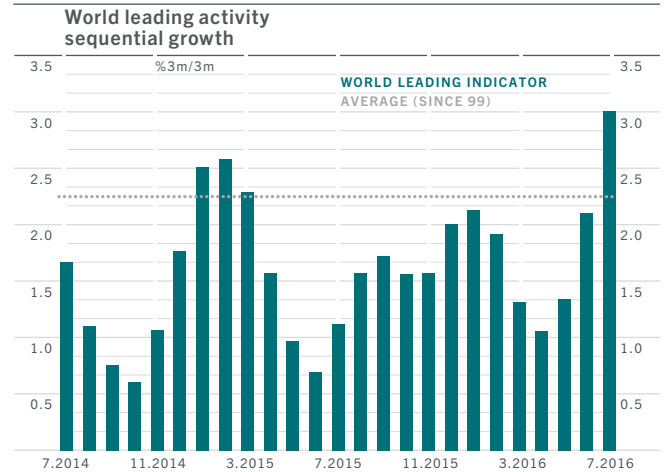
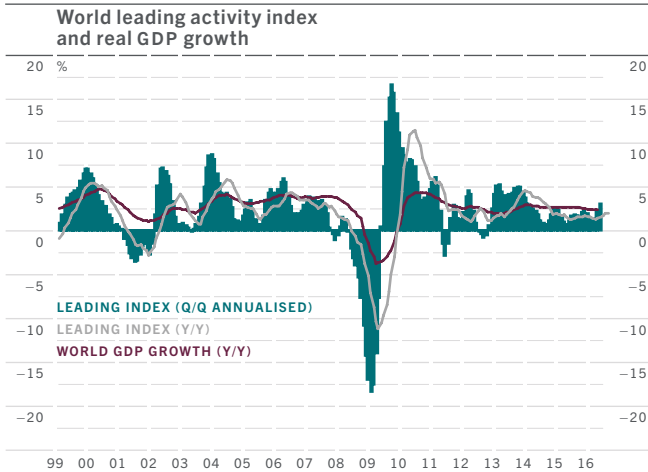


Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

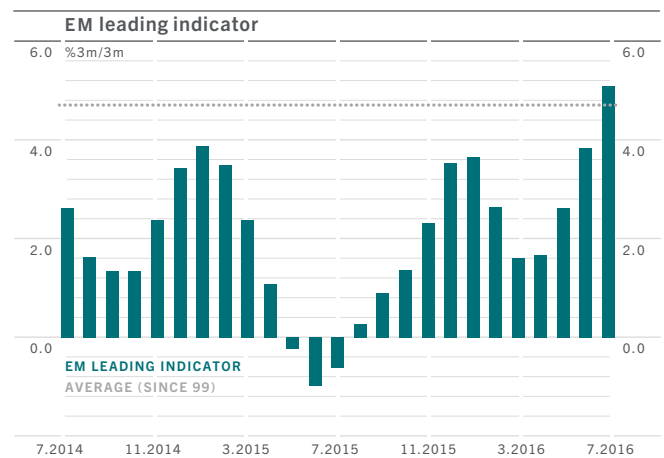
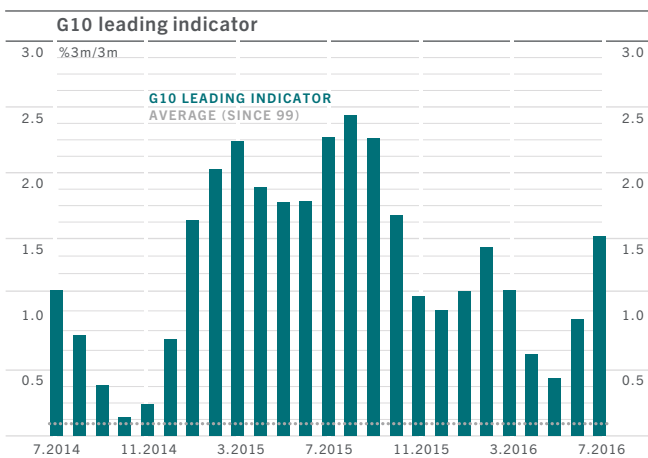
### Risk bias indicators

RISK BIAS INDICATORS	UNDERWEIGHT	NEUTRAL	OVERWEIGHT	MONTHLY CHANGE
	-	0	+	<<<< >>>>
Business cycle				
Liquidity				
Valuation				<
Technicals				
PAM Strategy				

### Business cycle: World economic growth continues to build



### G10, EM economic momentum pick up



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

### Valuation: Equity markets and sectors

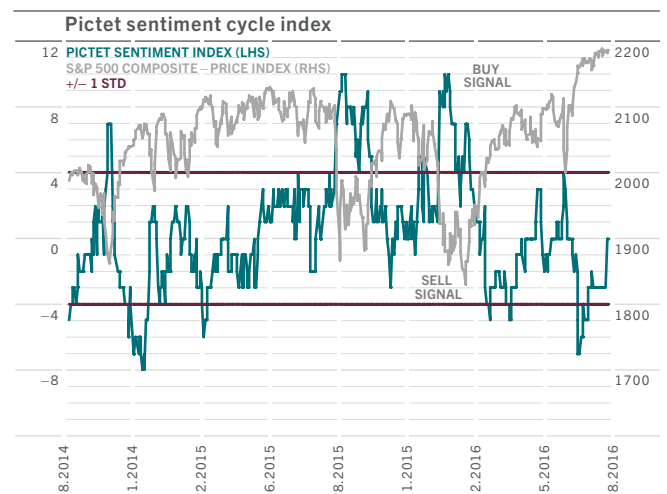
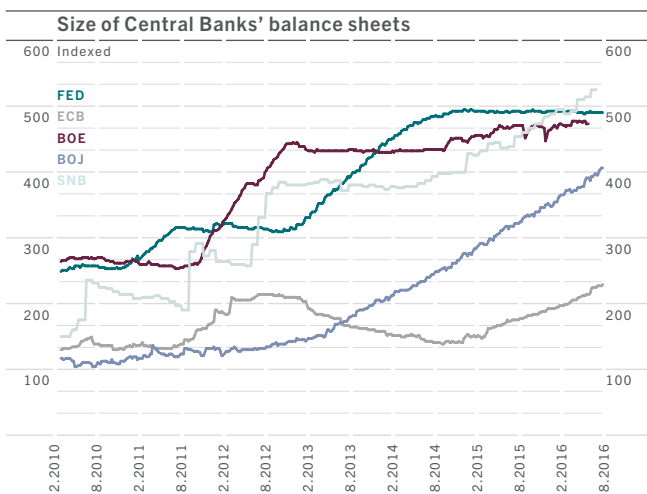
Countries and sectors										
MSCI REGIONS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY	
	2016	2017	2016	2017	2016	2017	2016E	2016E	2016E	
US	1%	13%	2%	6%	18.7	17.2	2.8	1.9	2.1%	
EUROPE	-2%	13%	0%	5%	16.5	15.2	1.7	1.2	3.6%	
EMU	1%	13%	1%	4%	14.9	13.7	1.4	0.9	3.6%	
SWITZERLAND	-3%	10%	1%	3%	18.6	17.5	2.4	2.3	3.3%	
UK	-6%	16%	-3%	8%	17.8	16.0	1.8	1.3	3.9%	
JAPAN	9%	10%	-3%	3%	13.9	13.4	1.1	0.7	2.4%	
EM	7%	13%	3%	10%	13.4	12.3	1.5	0.8	2.6%	
NJA	2%	11%	3%	9%	13.7	12.8	1.4	0.8	2.6%	
GLOBAL	1%	13%	1%	6%	17.2	15.8	2.0	1.4	2.6%	

MSCI SECTORS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
	2016	2017	2016	2017	2016	2017	2016E	2016E	2016E
ENERGY	-39%	95%	-11%	19%	37.0	22.7	1.4	0.9	3.5%
MATERIALS	9%	16%	-5%	5%	19.2	17.2	1.7	1.1	2.2%
INDUSTRIALS	9%	10%	0%	4%	17.5	16.4	2.5	1.0	2.4%
CONSUMER DISCRETIONARY	9%	12%	4%	5%	17.0	15.8	2.6	1.1	2.0%
CONSUMER STAPLES	5%	11%	4%	5%	22.5	20.9	4.2	1.4	2.5%
HEALTH CARE	7%	10%	8%	5%	17.6	16.5	3.6	2.0	1.9%
FINANCIALS	-3%	8%	3%	4%	12.6	11.9	1.1	1.6	3.5%
IT	3%	13%	1%	5%	18.5	17.0	3.3	2.4	1.6%
TELECOMS	7%	9%	4%	3%	15.9	15.1	2.2	1.4	4.0%
UTILITIES	-3%	3%	-2%	2%	15.7	15.4	1.5	1.0	3.7%

### Liquidity: Central bank stimulus remains abundant

### Sentiment indicator in negative territory



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

Japan is also on course for a recovery as we see signs of a pick-up in private consumption and a rise in inflation-adjusted wages.

Within the emerging world, our leading indicators point to a considerable quickening of economic expansion. The shift has been particularly pronounced in Latin America, and we may increase our growth forecasts for the region as a result. Asia's economic prospects are less encouraging, however, primarily because of uncertainties hanging over China. Although the country's leading indicators have been heading higher for some months, we are concerned that economic growth will soon plateau, reflecting declines in both investment and real estate activity as the impact of monetary and fiscal stimulus start to fade.

Our **LIQUIDITY** readings paint a positive picture overall, suggesting that the rally in riskier asset classes should continue for at least another couple of months. Fresh stimulus from both the BoE – which cut rates by 25 basis

points and resumed quantitative easing – and the Bank of Japan has been instrumental in driving our gauges into bullish territory. In the euro zone, meanwhile, the volume of excess liquidity in the financial system is close to EUR1 trillion, according to ECB estimates.

But developments have not been universally positive.

China remains a weak spot. Private investment within the country has seen a sharp deceleration; the rate of growth has fallen from some 12 per cent annualised just a few months ago to little more than 2 per cent. What is more, Chinese corporations, particularly those operating in industries experiencing falling capacity, have chosen to pay back debt rather than invest.

Separately, our gauges show a growing dispersion in the **VALUATION** of regional stock markets and equity sectors. Japanese stocks are the cheapest of all the asset classes in our scorecard while emerging market and UK equities are approaching fair value following their recent gains. Financials and telecom stocks are the only industry sectors that are very attractively valued. Overall, however, equities should continue to draw support from encouraging developments in corporate earnings. For instance, in the US, second quarter earn-

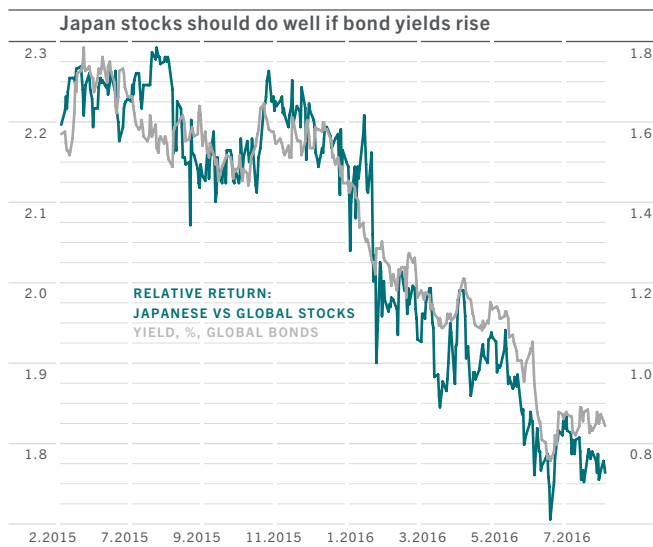
ings per share fell 2.2 per cent year-on-year, a substantial improvement on the 5.5 per cent yearly decline registered in the previous three months.

The ratio of corporate earnings forecast upgrades to downgrades is also moving in a positive direction worldwide, with the upward move most pronounced in emerging markets. Elsewhere, our model shows that bonds are at their most expensive ever level.

**TECHNICAL** indicators point to a possible sell-off in parts of the fixed income market, notably non-government bonds, which have seen strong flows in recent months. The technical picture is also negative for emerging assets, particularly debt, which has also seen exceptionally strong investment inflows in recent months. Our gauges suggest that equities may build on their gains: the number of stocks and industry sectors participating in the market rally has continued to rise.



## Japan and emerging markets offer the best prospects



**W**e keep our preference for equities in Japan, where valuations are attractive and an expanded monetary stimulus package is set to lift growth and stands to boost corporate earnings. The prospects for emerging market stocks are also encouraging.

Japan is the developed market that will benefit the most from accelerating global growth. Because its companies have some of the highest levels of operating leverage in the world – a reflection of high input costs and inflexible labour markets – Japan experiences an above-average boost to corporate earnings whenever global demand rises. And with our indicators pointing to an expansion in growth rates worldwide, we expect corporate Japan to overcome some of the forces that have recently held it back, such as a strong yen, which has dented the attractiveness of its exports, and slowing growth in China. Indeed, we are starting to see the first indications that company earnings are approaching a turning point, with the number of analyst corporate profit forecast upgrades now outnumbering downgrades.

Also likely to support Japanese stocks is a rise in global government bond yields – which we see as highly likely. Historically, there is a very stable positive relationship between government bond yields and Japanese stocks as the former is a good proxy for market expectations for nominal GDP growth. Japanese equity markets tend to outperform their counterparts when global bond yields rise (see chart).

Elsewhere, the earnings of emerging market companies have also been improving thanks to an encouraging macro-economic backdrop. Beijing's fiscal and monetary stimulus measures have managed to stabilise the Chinese economy and helped shore up investor confidence after a surprise currency devaluation at the beginning of the year had unsettled sentiment.

Even so, with emerging market stocks having gained some 15 per cent year to date, and as monetary easing gradually becomes less effective, the rally may slow somewhat in the coming months.

Separately, while the euro zone seems to have weathered the shock of the UK vote to leave the EU, little has been done to address the fundamental vulnerability of Italy's weakest banks, which may need to be recapitalised. This is why we are reluctant to lift our exposure

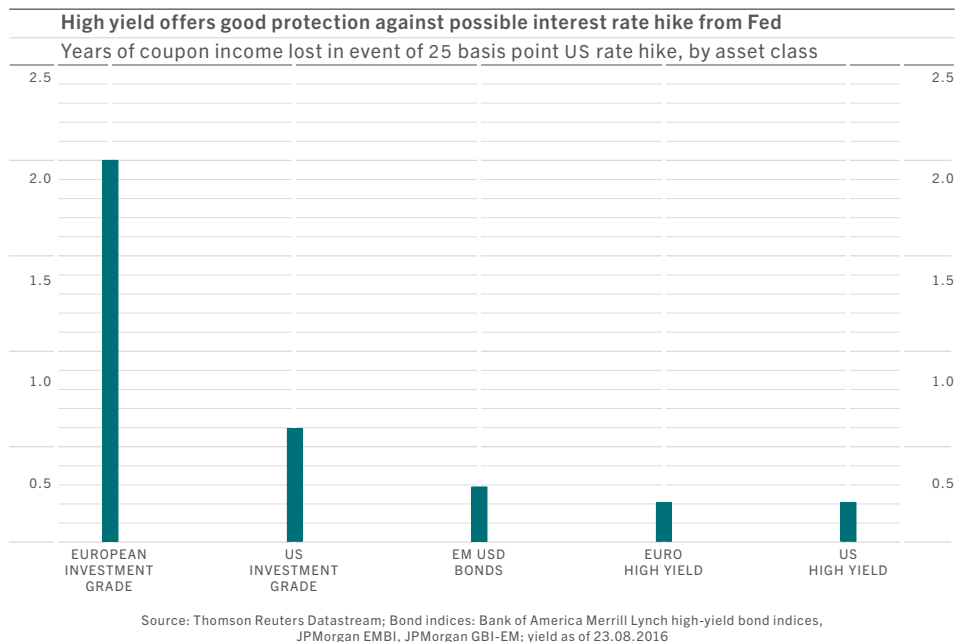
to the region, even though it appears relatively inexpensive when measured against both its growth prospects and other major equity markets.

Meanwhile in the US, high valuations – US stocks' price-to-book ratio is now at 3, the highest since the market reached its peak in 2007 – means they offer little prospect of outperforming other markets, even if corporate earnings per share surpass consensus forecasts.

The wide dispersion of valuations among industry sectors currently means there is potential to generate excess investment returns via sector allocation. In an environment where economic growth is defying expectations, we favour exposure to cyclical sectors. By our calculations, cyclical stocks have the potential to rise some 5 to 10 per cent more than defensive stocks through to the end of the year, not least because they are cheaper than sectors that are insensitive to economic growth.

Within cyclicals, we have a preference for sectors that have no direct exposure to commodity markets, which we believe may have peaked. We also favour stocks that have no obvious structural impediments to growth. Technology stocks, which continue to trade at reasonable valuations, are benefiting from positive earnings momentum; industrials stand to gain from a recovery in capital spending while consumer discretionary stocks have the potential to recover having lagged other cyclicals year-to-date. Although financials trade at unusually low valuations and could be set for a bounce, any rally is likely to prove short lived, given the plethora of structural problems that continue to bedevil the sector, such as onerous regulations and negative interest rates.

## Governments bonds due a correction but credit rally to continue



In a landscape of unprecedentedly low bond yields, we continue to find a pocket of value in European high yield credit in particular. But, more generally, we remain cautious about the fixed income market. We expect the downward trend in yields to reverse amid an improvement in global economic growth.

June's Brexit referendum has further eased monetary policy worldwide, with the BoE restarting quantitative easing and cutting interest rates, the ECB maintaining its dovishness and the Fed given a reason to delay further tightening yet again.

The resulting rally across sovereign debt markets has left around a third of all developed market government bonds with negative yields.

According to one estimate, the value of negative yielding bonds in the global debt market was USD13 trillion in mid-August, with around half of euro zone and three quarters of Japanese sovereign debt offering yields of less than zero. Given that bond yields are falling while nominal GDP is rising – a trend that sits starkly at odds with the historical norm – we expect a market correction in government debt markets over the coming months.

We therefore remain underweight euro zone, Japanese, Swiss and UK government bonds – there is no value in European or Japanese government bonds under nearly any possible scenario in our view – though our preference remains for US bonds given that Treasury yields are higher than those of most other markets.

The risk that inflationary pressures will build amid a tight US labour market makes US inflation-protected bonds – or TIPS – an attractive hedge in a global portfolio. Speculation the Fed might increase its inflation target from 2 per cent or move to nominal GDP targeting further supports the case for TIPS.

We remain neutral on emerging market local- and US dollar-denominated debt. Growth and inflation trends may have become encouraging across the emerging world, but both asset classes have been on a strong run this year thanks to very heavy investment inflows; yields on local currency debt are now at the bottom of their historic range of between 6 and 7 per cent. As the probability of a December US interest rate hike rises, emerging market debt will grow increasingly vulnerable to a correction.

There remains an investment case for staying overweight both the European and US high yield credit.

For one thing, both offer good protection against a possible rise in US rates (see chart).

The impact of the ECB's corporate bond buying programme, meanwhile, has filtered through to high yield. Favourable fundamentals – low inflation and signs of a pickup in euro zone economic growth – should offer high yield further support.

The US market is also attractive, though the scope for strong gains is limited. Implied default rates among speculative-grade borrowers are fair in our view, while financial conditions are becoming more difficult amid tightening bank credit standards, suggesting the credit cycle is about to enter a more challenging phase.

In currencies, we remain underweight the Japanese yen. We anticipate weak nominal GDP to trigger further and perhaps more extreme heterodox monetary measures in Japan, which makes the currency vulnerable to a correction given that it is at its most expensive level in at least 15 years on our valuation metrics. By contrast sterling is likely to stabilise as post-Brexit growth risks are less severe than we and much of the rest of the market had anticipated.

Finally, we continue to hold an overweight position in gold against the risks of policy turbulence, particularly ahead of this autumn's US elections.

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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

### **TECHNICALS**

Pictet sentiment index (investors' surveys, tactical indicators)

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