

August 2016

# BAROMETER

Equities bask  
in summer glow

## **GLOBAL ASSET CLASSES**

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We keep our overweight stance in global stocks, in anticipation of improving world growth.

## **EQUITY REGIONS AND STYLES**

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We upgrade US and emerging market stocks as they benefit the most from moderate global growth; Europe is downgraded to neutral.

## **EQUITY SECTORS**

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We raise industrials to a single overweight; materials move down to neutral. Otherwise we keep a cyclical tilt.

## **FIXED INCOME**

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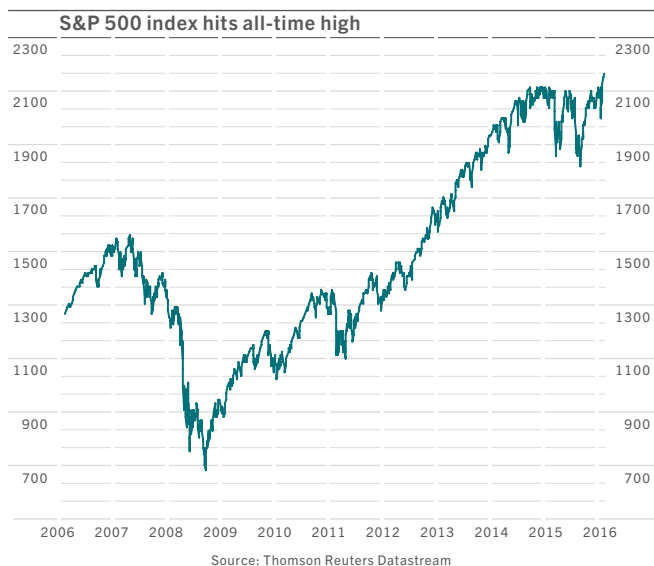
We cut US high yield to a single overweight after strong gains; emerging market hard currency debt moves to neutral.

	UNDERWEIGHT —	NEUTRAL 0	OVERWEIGHT +	MONTHLY CHANGE	
				<<<<	>>>>
<b>ASSET CLASSES</b>			Equities		
	Bonds				
			Cash		
<b>EQUITIES</b>		US			>
		Euro		<	
		Swiss			
			UK		
			Japan		
			Emerging markets		>
		Pacific ex-Japan			
<b>GLOBAL INDUSTRY SECTORS</b>		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.

## Wall Street, emerging markets march higher



Equities rose in July, outperforming bonds as the recent run of upbeat US economic data and the prospect of monetary and fiscal policy stimulus in the world's key economies helped counter any negative shocks from Britain's vote to leave the European Union. G20 policymakers reiterated their pledge to support the global economy at their meeting, saying that they would use "monetary, fiscal and structural" tools to do so.

The S&P 500 index hit a record high, bringing this year's gains to more than 7 per cent (see chart). Wall Street rose the most among developed equity markets, further widening this year's performance gap over Japan and Europe, which remain in negative territory.

Global IT and material stocks were the biggest winners, while staples lagged. Energy was the only sector that ended the month in red.

But even the S&P failed to keep up with emerging market equities, which gained nearly 5 per cent in July to hit a nine-month high as post-Brexit capital inflows accelerated. Emerging hard currency and corporate bonds also rose.

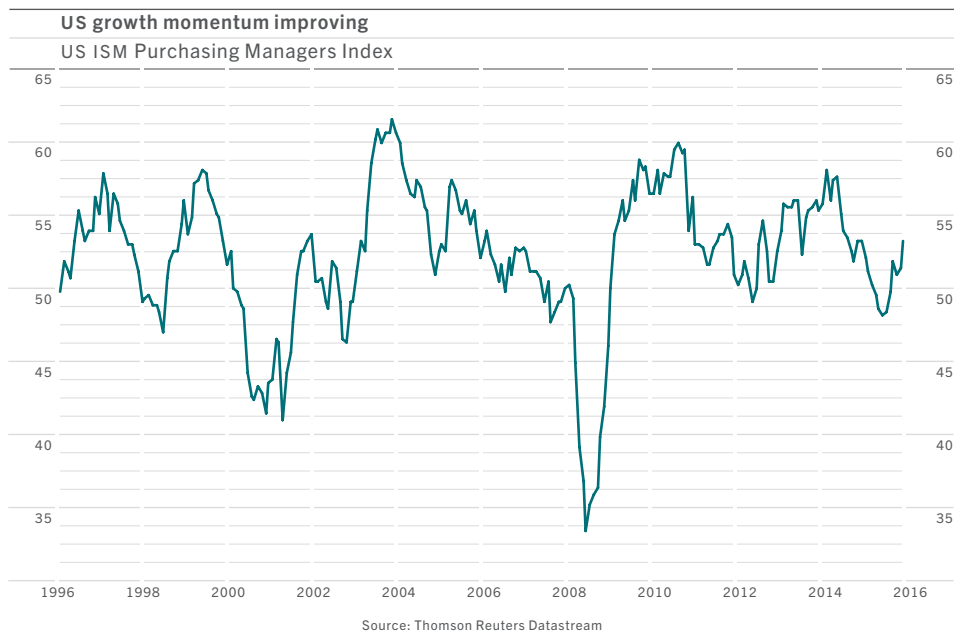
Government bond markets fared less well, especially in developed economies as investors switched to equities from sovereign debt that is yielding at or below zero. German 10-year yields briefly hit a record low of minus 0.20 per cent earlier in the month before rising.

In credit, US high yield debt rose further, extending this year's gains to more than 12 per cent as the asset class attracted yield-seeking flows.

The dollar rose more than 1 per cent, hitting a four-month high against a basket of currencies as better-than-expected US data revived expectations the Federal Reserve would raise interest rates later this year. The yen surged after the Bank of Japan delivered fiscal stimulus that fell short of market expectations, but it ended the month down almost 2 per cent against the dollar.

Oil prices lost more than 10 per cent, dragging commodity indices lower as worries grew over a global glut of crude and refined products and as the dollar moved higher. Gold ended the month flat, but it is one of the best performing asset classes after gaining more than 25 per cent since January.

## Equities to extend summer run as Brexit shock fades



Global financial markets have recovered poise as a sell-off after Britain's vote to leave the European Union proved short-lived. World economic growth remains moderate and central banks in Europe, Japan and some emerging economies continue to provide monetary stimulus, while the US Federal Reserve is unlikely to raise interest rates before December. This provides a positive backdrop for risk assets and we therefore stick to our overweight stance in equities and underweight in bonds. We keep our overweight position in gold as a hedge against future volatility.

According to our **BUSINESS CYCLE** indicators, the US economy is enjoying better growth momentum (see chart), thanks to higher consumer spending and a solid housing sector.

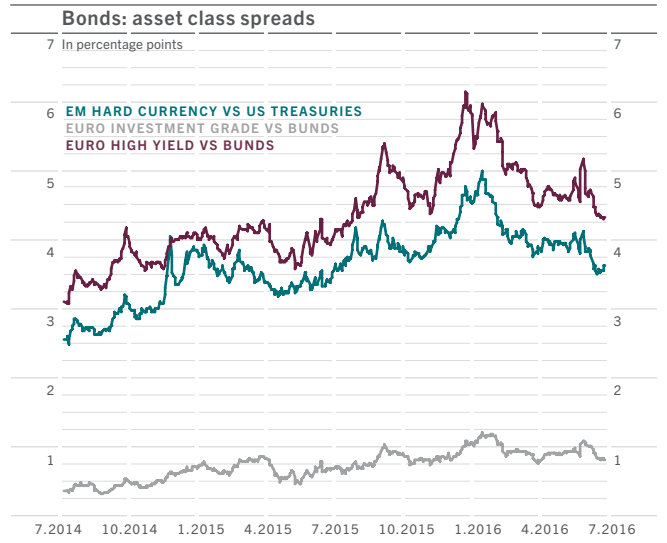
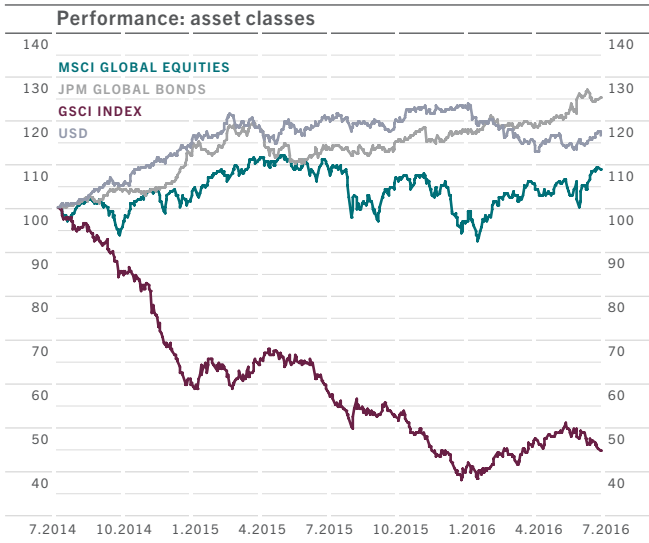
Manufacturing activity is also stabilising while there is a tentative sign of an increase in capital spending. All of which points to an upside risk to our 2016 GDP forecast of 2 per cent, which is in line with the US's potential growth rate. The market is pricing in a one in two chance of an interest rate hike in December, but overall monetary conditions should remain supportive of growth as a recent pick-up in inflation is likely to be temporary and the labour market remains tight.

Economic activity is improving in the euro zone too as private consumption gains pace and external demand recovers somewhat. Sentiment remains fragile after Brexit but the euro zone economy is proving resilient, allowing for above-potential growth of 1.3 per cent this year. Italy remains a weak link given uncertainty over plans to recapitalise its banks, which are saddled with some EUR200 billion (gross) of bad loans – a third of the euro zone's total.

The European Central Bank made no changes to monetary policy in July but reiterated that it would take necessary action. We think the ECB may extend the timeframe for its asset purchase programme beyond March to counter any negative surprises to the economy.

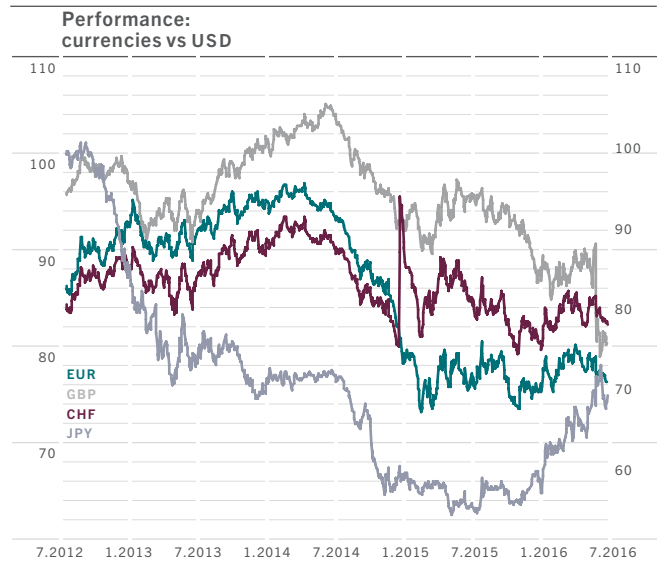
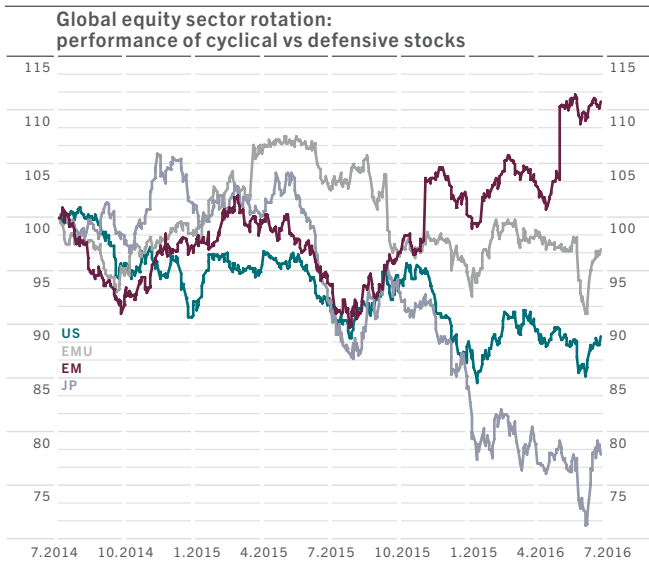
Japan's growth is likely to remain below potential at 0.7 per cent this year as business investment remains subdued despite higher public and private spending, an upbeat housing sector and a moderate recovery in external demand. The BOJ expanded monetary stimulus by almost doubling its purchases of exchange-traded funds, but it disappointed investors by refraining from venturing into more unconventional monetary policy. It maintained its base money target at JPY80 trillion and the pace of purchases of other assets, including

### Major asset classes



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AUGUST 2016

### Equity sector rotation and currency performance

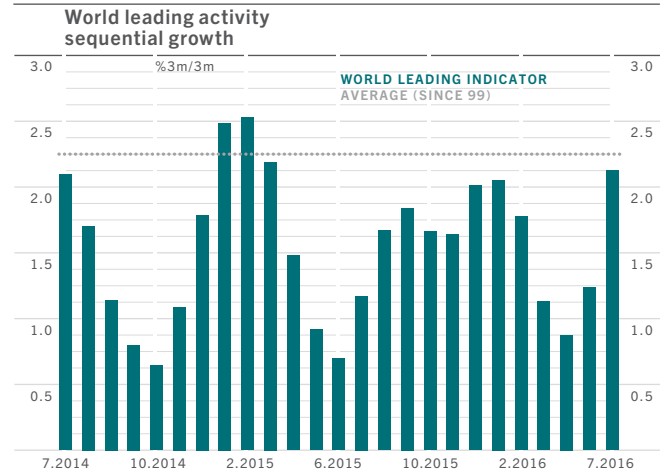
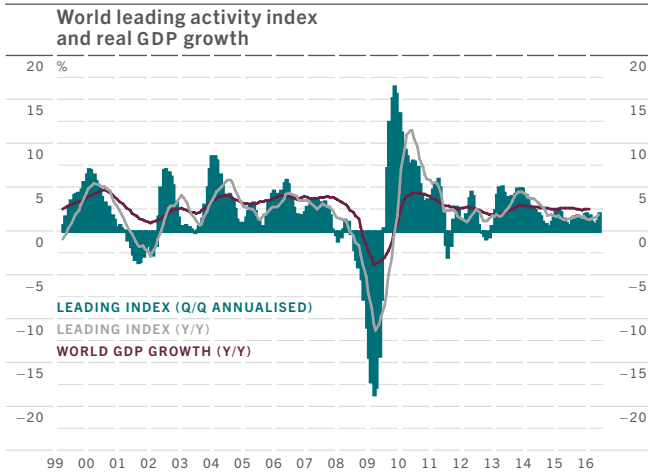


Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

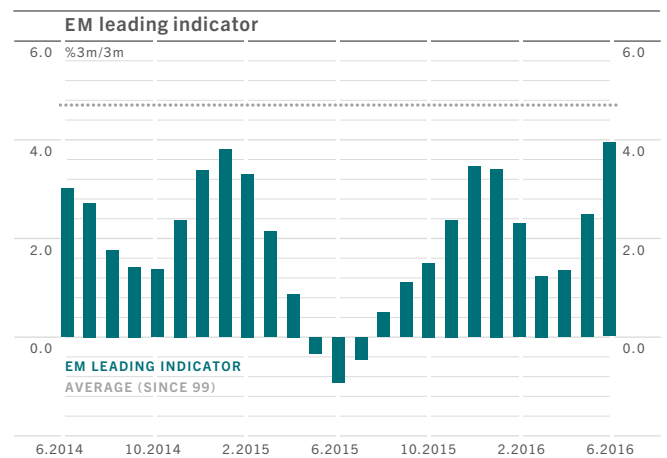
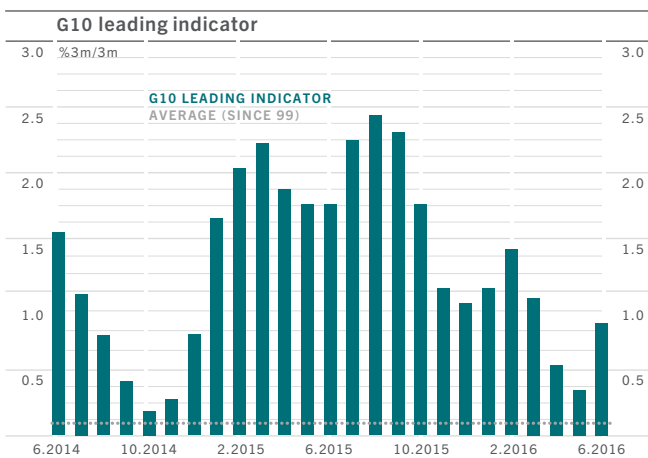
### Risk bias indicators

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

### Business cycle: World economic growth remains moderate



### G10, EM economic momentum pick up



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

### Valuation: Equity markets and sectors

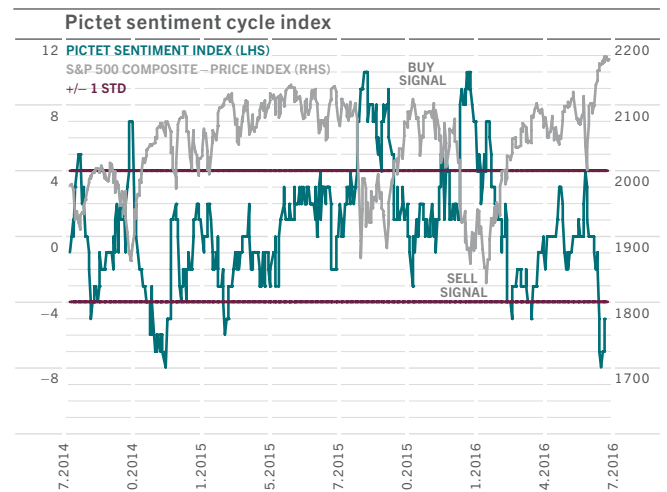
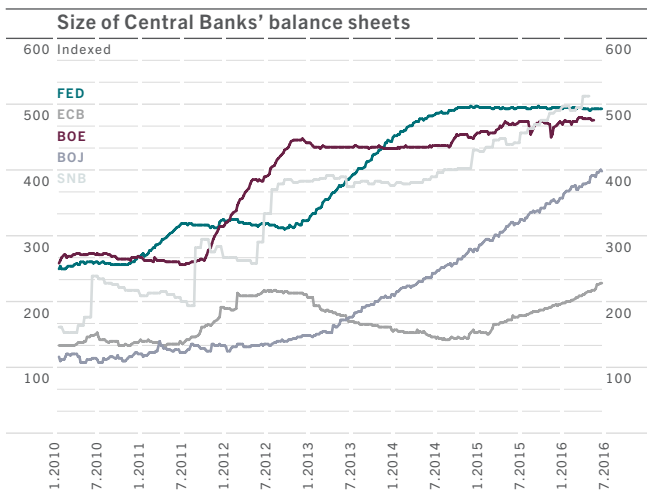
Countries and sectors										
MSCI REGIONS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY	
	2016	2017	2016	2017	2016	2017	2016E	2016E	2016E	
US	1%	14%	2%	6%	17.4	16.2	2.6	1.8	2.3%	
EUROPE	-1%	14%	-1%	6%	14.6	13.6	1.5	1.1	4.1%	
EMU	2%	13%	0%	4%	13.4	12.6	1.3	0.9	3.9%	
SWITZERLAND	-1%	11%	1%	4%	17.3	16.4	2.3	2.2	3.5%	
UK	-7%	17%	-3%	9%	16.6	15.2	1.7	1.2	4.3%	
JAPAN	15%	8%	-1%	3%	12.4	12.1	1.0	0.7	2.6%	
EM	6%	14%	3%	10%	12.4	11.6	1.3	0.8	2.8%	
NJA	2%	12%	3%	9%	12.6	12.0	1.3	0.7	2.8%	
GLOBAL	2%	13%	1%	6%	15.8	14.7	1.9	1.3	2.8%	

MSCI SECTORS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY	
	2016	2017	2016	2017	2016	2017	2016E	2016E	2016E	
ENERGY	-41%	97%	-12%	20%	36.4	24.6	1.3	0.9	3.7%	
MATERIALS	6%	17%	-5%	5%	17.4	15.9	1.6	1.0	2.5%	
INDUSTRIALS	12%	11%	2%	4%	15.6	14.9	2.2	0.9	2.6%	
CONSUMER DISCRETIONARY	11%	12%	5%	5%	15.3	14.4	2.4	1.0	2.2%	
CONSUMER STAPLES	5%	10%	3%	5%	21.4	20.3	4.0	1.3	2.6%	
HEALTH CARE	7%	11%	8%	6%	16.5	15.7	3.4	1.8	2.1%	
FINANCIALS	-1%	10%	3%	5%	11.2	10.7	1.0	1.4	3.9%	
IT	3%	13%	2%	5%	16.5	15.4	3.0	2.1	1.7%	
TELECOMS	7%	9%	4%	2%	15.4	14.9	2.1	1.3	4.1%	
UTILITIES	-3%	4%	-1%	2%	15.4	15.1	1.5	1.0	3.8%	

Liquidity: Fed likely to stay on hold; stimulus provided by other central banks

Sentiment indicator in negative territory



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

Japanese government bonds. The government is likely to implement an additional fiscal package of as much as JPY28 trillion.

China's economy remains stable, thanks to Beijing's economic support measures on fiscal, monetary and property fronts. However, construction activity appears to be peaking, while credit growth is likely to slow down as authorities begin to rein in excessive growth in borrowing. Elsewhere in emerging economies, the growth outlook remains underpinned by China's stabilisation, an on-hold Fed and monetary and fiscal support measures.

Our **LIQUIDITY** readings stand at a neutral level for the third consecutive month. Expectations for easy mone-

tary and fiscal policy in Japan, China, Britain and the euro zone are likely to improve global liquidity conditions in the coming months. However, in the US, the Fed looks more likely to raise interest rates this year, and changes in regulations of money market funds are impacting funding costs.

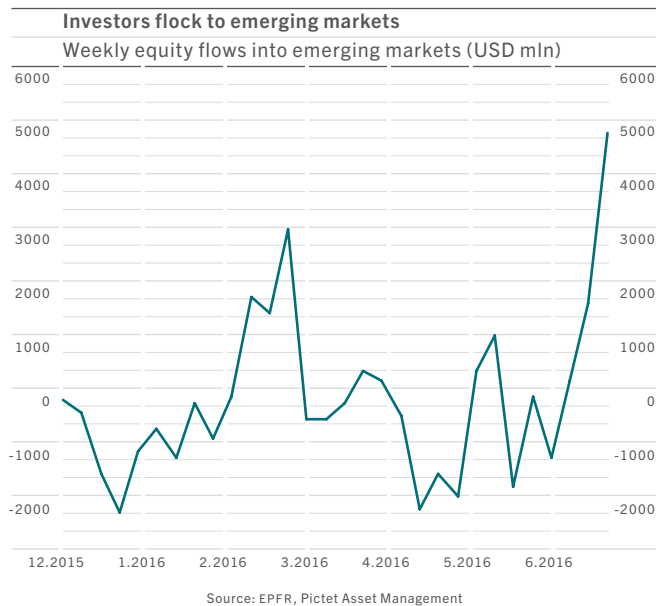
Our **VALUATION** signals show equities are no longer as cheap as they used to be, especially in the US, Japan and Britain and in energy, materials, healthcare and consumer staples sectors. However, our scorecard shows equities are at their most attractive relative to bonds since 2012. It's worth noting that US equities are at a record high and bond yields are close to all-time lows – a rare combination of events that has happened only five times in the past 100 years. Moreover, US companies may

have passed the worst of earnings downgrades as the proportion of S&P 500 companies beating earnings estimates hit 84 per cent, the highest since 2009.

Our **TECHNICAL** readings are positive for both equities and bonds despite stretched sentiment for US stocks. Gold has been in overbought territory for two consecutive months, but there is still some room for the precious metal to outperform given a positive seasonal effect.



## Europe and the US back in neutral; staying long Japan and the UK



**W**e have raised US equities and cut European stocks to neutral. US equities may be trading at more expensive multiples than European counterparts, but we think there is still room for the equity market to appreciate as the recent batch of US economic data points to surprisingly strong growth in the world's biggest economy and positive earnings growth. A Federal Reserve that is unlikely to raise interest rates before December should also help underpin risky assets. Valuations in US stocks are nowhere near bubble territory yet, while those in bonds have reached far more excessive levels.

Europe on the other hand is cheap for a reason – it has failed to address a wide range of growth-sapping structural problems and the region remains vulnerable to political instability ahead of presidential elections in France and Germany. Concerns over Italy's debt-laden banks could also shake the region to the core. The ECB, which has been the only institution keeping the currency bloc together, may start to run out of ammunition. We are also sceptical about the efficacy of further monetary stimulus in the euro area.

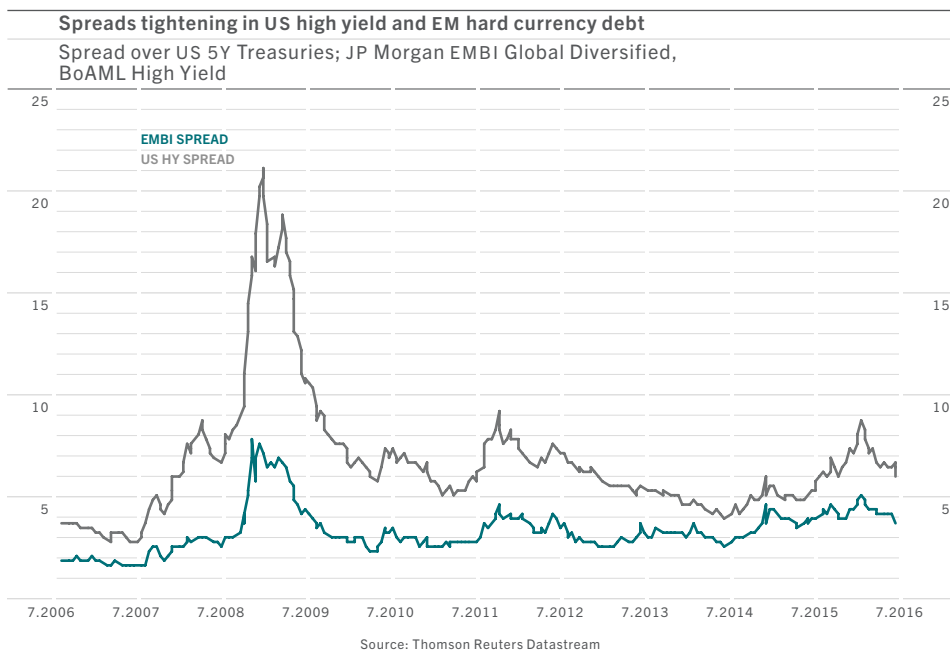
We have raised the score on emerging markets to a single plus. Economic fundamentals have improved as the perceived risk of near-term financial instability in China has receded. We also note that liquidity conditions in several large emerging countries are positive on our measures. What is more, there are signs that strong US domestic demand is finally beginning to lift exports in some Asian countries, while Russia and Brazil are beginning to come out of deep recessions. A technical indicator has also turned green: data from the Institute of International Finance shows that investors are starting to reverse their long-held underweight positions in emerging markets, with USD8.3 billion flowing into EM stocks since the Brexit vote. This is the highest level since the Fed delayed scaling back its bond buying programme in September 2013.

The UK and Japan remain overweight as we expect further policy stimulus, which should benefit their equity markets. The Bank of England is widely expected to renew its stimulus efforts to head-off a post-Brexit downturn, following a drop in consumer confidence and early signs of retrenchment in key industries. Fresh measures could include a cut in interest rates and further quantitative easing. Japan is also

expected to respond to the shock of Brexit, which triggered a surge in the safe-haven yen that has been choking exporters, with a sizeable stimulus package. According to our model, the valuation of Japanese equities is currently extremely cheap, at some two standard deviations from the long-term average.

Among equity sectors we continue to favour cyclicals, which are most exposed to a recovery in economic growth and exhibit a 5-7 per cent upside on our model in aggregate. These shares currently trade at a 10 per cent discount to the cyclically-adjusted Shiller price-earning ratio – a level consistent with a recession, compared with the 10 percent premium they typically trade at. Within cyclicals we have shifted our bias from the materials sector to industrials. We believe that fiscal spending on infrastructure is going to become an increasingly attractive political programme for either incumbent governments seeking to bolster their position or from populist forces trying to find an alternative to global trade. High-yielding utilities, by contrast, are weighed down by weak earnings prospects. And with the performance of utility stocks and government bonds closely correlated, there is also limited room for such stocks to rise when global bond yields stand at all-time lows.

## Trimming US high yield and emerging market dollar debt



Most developed market government bonds remain at extreme valuations. Indeed, some became even more expensive in the wake of the Brexit referendum as investors anticipated further monetary policy stimulus to mitigate the poll's economic fallout.

As a result, we have kept our positioning on these bonds unchanged, staying underweight on all except for US Treasuries. Only the US retains any residual value at the long end, which we view as one of our last safe haven assets. This is useful against potential flashpoints, not least the Italian banking sector. Failure to resolve its bad debt problems could yet trigger a generalised flight from risk.

But even the case for long-dated Treasuries isn't clear-cut after yields collapsed during the month. That's because the US economy's fundamentals are increasingly positive. Growth momentum has improved as has consumption, more than offsetting any weakness in manufacturing activity.

Wage growth, meanwhile, has been accelerating. The Fed's own measure shows wages have been rising at 3.6 per cent a year, which is broadly around the Fed's target levels.

Nonetheless, the market is ascribing only a 28 per cent probability to a Federal Reserve rate rise in September and only a 50 per cent chance in December. Set against the backdrop of a robust economy, a tight labour market and rising earnings, this suggests the Fed will find itself behind the curve. Policy could end up having to play catch-up to control rising inflation.

These factors have the potential to trigger a sharp steepening of the Treasury curve, with Fed policy having ever less traction beyond the short end of the market. One way to mitigate these risks would be to seek protection in the form of inflation-indexed bonds.

We have cut our stance on emerging market hard currency debt and US high yield bonds following their strong performance over recent months, reducing the former to neutral and the latter to a single plus from full-overweight.

Desperation for yield has sent money flooding to any and every corner of the market offering income (see chart).

But the case for high yield debt relative to equities is less compelling after the yield gap between US equities and US high yield has fallen to 1 percentage point from 3.7 in February. Now is the time to start taking profits.

We have made no changes to currencies. We keep our underweight stance on the yen, which remains vulnerable to a large Japanese stimulus package.

Finally, we continue to overweight gold bullion as a long-term hedge against significant monetary debasement, which seems an inevitable ultimate consequence of ever more aggressive central bank policy. Especially now that experiments in direct monetisation of fiscal spending no longer seem to be anathema to policymakers.

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Issued August 2016  
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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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