

February 2016

# BAROMETER

No need for panic

## GLOBAL ASSET CLASSES

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We retain our overweight recommendation on equities as we believe the market sell-off has taken valuations to attractive levels; bonds remain expensive in the main.

## EQUITY REGIONS AND STYLES

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European and Japanese equities offer the best prospects; emerging market stocks also look attractive as economic conditions are slowly stabilising in the developing world.

## EQUITY SECTORS

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We cut financials to neutral, partly in response to upheaval in the Italian banking sector.

## FIXED INCOME

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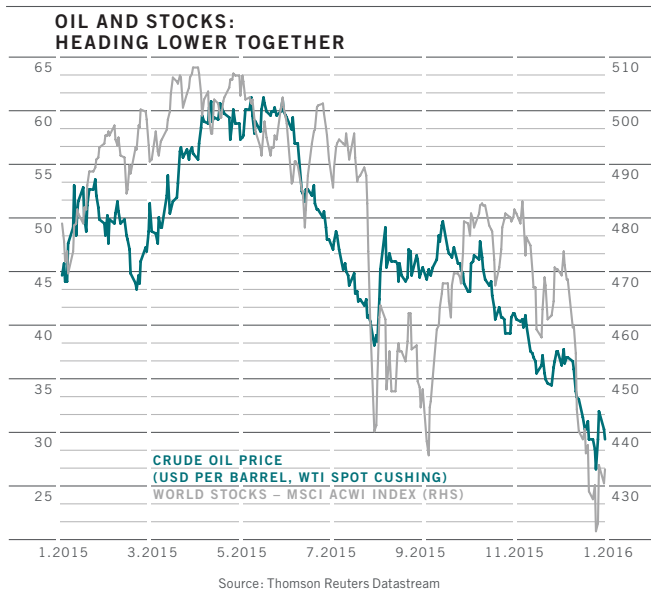
The risk-return profile of both US high-yield debt and emerging market local currency debt remains compelling.

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

## Risk-aversion hits stocks; government bonds rally



**G**lobal financial markets had a turbulent start to 2016 as concerns about the health of China's economy and a sharp decline in oil prices weighed on riskier asset classes. Signs of oversupply pushed crude oil to a 12-year low of below USD30 a barrel, hitting equity sectors and regions that are sensitive to energy prices. The Bank of Japan's surprise move to introduce negative interest rates at the very end of the month helped markets pare some of their losses. Still, the MSCI World ended down just over 6 per cent.

Developing world stock markets led the decline. Mainland Chinese shares hit a 14-month low as data showed China was expanding at the slowest rate since 1990 and as the renminbi fell against the US dollar, suggesting that the world's second largest economy may be facing a hard landing.

The prospect of a further rise in US interest rates was also unsettling for emerging equity markets, with investors worried that higher borrowing costs might overwhelm many of the developing world companies that have loaded up on dollar-denominated debt since 2009. Emerging market stocks are now trading at a 30 per cent discount to their developed counterparts (on a price-earnings basis). Italian stocks were the worst-performing de-

veloped market equities, reflecting concerns over the country's banking sector.

The pattern of returns across industry sectors also testified to the spike in investor aversion to risk – with defensive stocks generally faring better than cyclical ones.

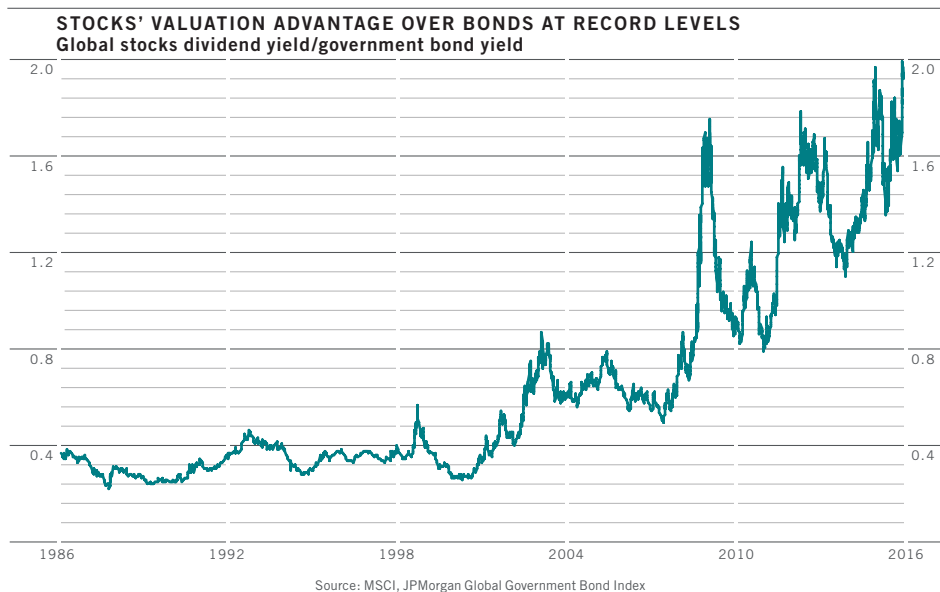
In fixed income, developed market government bonds staged a strong rally as investors sought safety. The benchmark 10-year US Treasury yield fell below 2 per cent while yields on 2-year German government bonds at one point hit a record low of -0.45 per cent after European Central Bank (ECB) President Mario Draghi indicated the central bank was ready to provide more monetary stimulus to support the economy.

Despite his pledge, however, long-term euro zone inflation expectations fell to a 3-1/2 month low, with the five-year, five-year breakeven forward rate – which shows where investors expect inflation to head over the long term – holding at around 1.60 per cent, well below the ECB's target of roughly 2 per cent. In the US, the same measure of inflation fell to about 1.50 per cent, the lowest since 2009, and well below the US Federal Reserve's target of 2 per cent.

High yield corporate bonds declined by 1.5 per cent in the US and Europe as tighter liquidity conditions prompted investors to demand greater compensation to hold risky debt.

The US dollar ended the month slightly higher against most major currencies, with its pace of appreciation slowing as investors scaled back expectations for future US interest rate hikes. The low-yielding Japanese yen had been the strongest developed market currency until the surprise decision by the BoJ to introduce negative rates sent it into reverse.

## Equities remain compelling



It has been a torrid start to the year, with most national stock markets registering monthly losses of at least 5 per cent. Last month, we raised our exposure to equities because we believed that the weakness in global growth would prove temporary. That move was clearly premature but we are sticking with our overweight position in stocks for a number of reasons.

For one thing, fears of a recession in the US are overblown. What is more, the Chinese economy, which has slowed markedly and caused much of the alarm sweeping through global markets, is gradually beginning to stabilise, according to our proprietary indicators.

Finally, with the dividend yield on global stocks now double the yield

investors can receive from global government bonds (see chart), equities are clearly a more valuable proposition than fixed income.

We are, however, mindful of the risks to world economic growth. Tightening liquidity conditions in the US and some recent weakness in US economic data (industrial production, manufacturing orders) are a concern.

But overall we retain a positive outlook.

Our proprietary economic indicators leave us optimistic on the current state of the **BUSINESS CYCLE**.

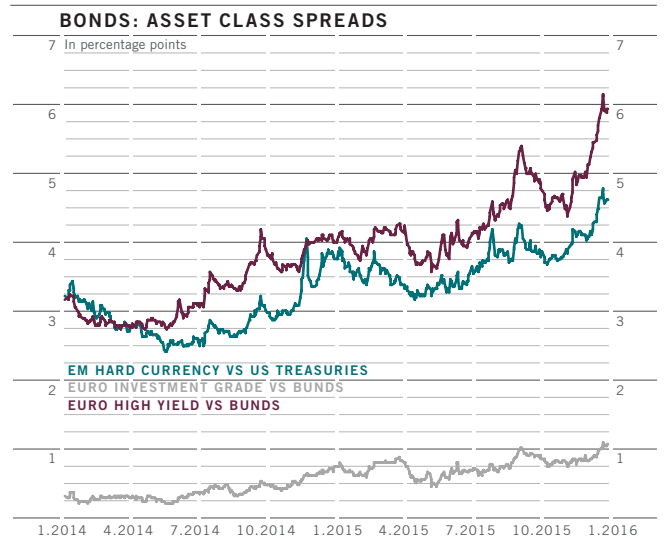
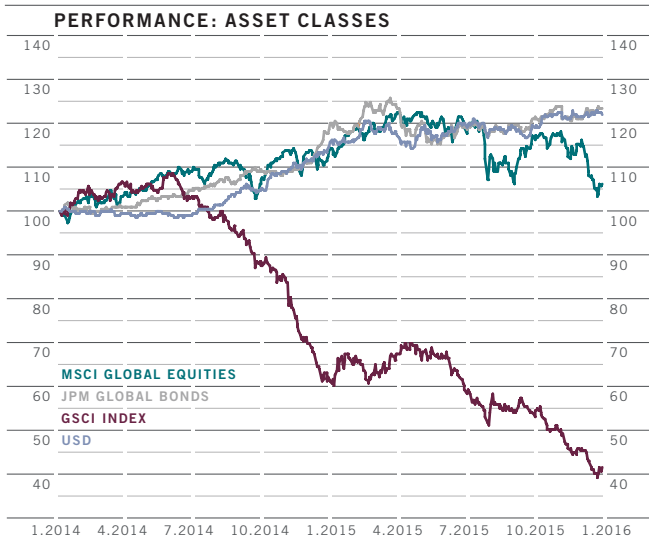
In the US, while economy is experiencing some difficulties, notably the strong US dollar's negative impact on the country's net exports, consumer spending is holding up well as lower energy prices have boosted disposable income. This does not look like an economy about to head into

recession. Indeed, only a small minority of the 24 indicators we have found to be reliable predictors of recession are flashing red. By our calculations, the probability of an economic slump stands at just 20 per cent, well below the level indicated by riskier asset classes such as US high-yield bonds, which put the probability of a contraction at about 80 per cent.

In Europe, conditions remain broadly positive with private and public investment and consumption all gaining pace thanks to monetary stimulus and low energy prices.

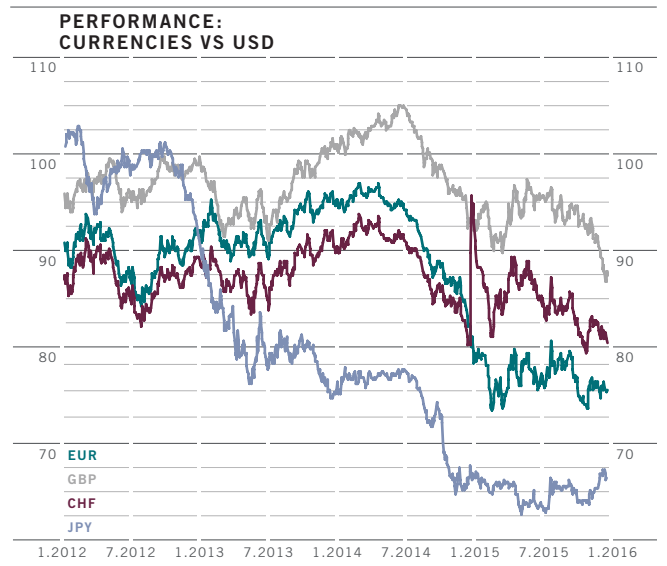
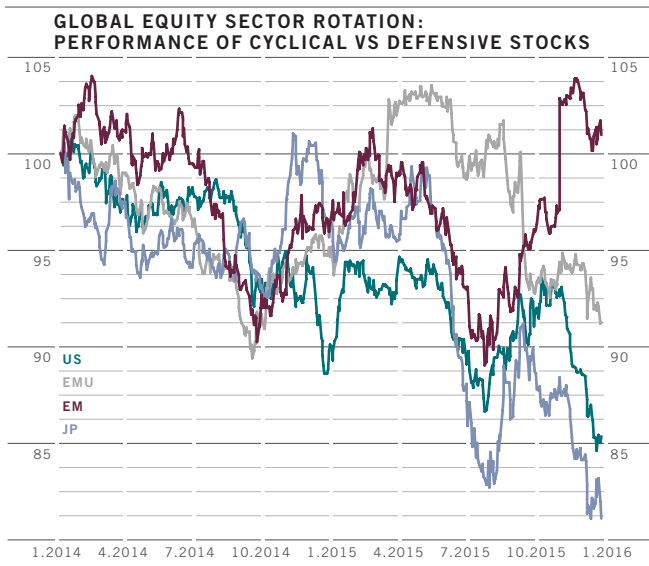
However, an increase in bad loans on the books of Italy's regional banks does pose a risk to the euro zone bank-

## Major asset classes

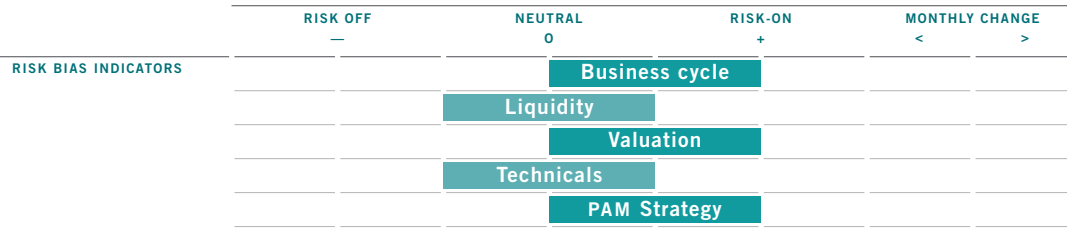


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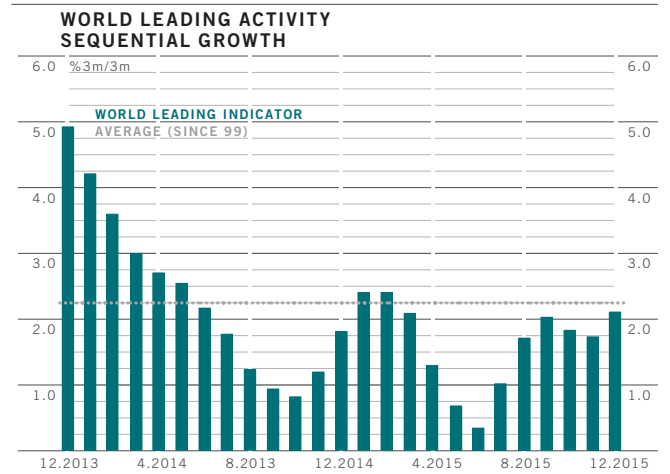
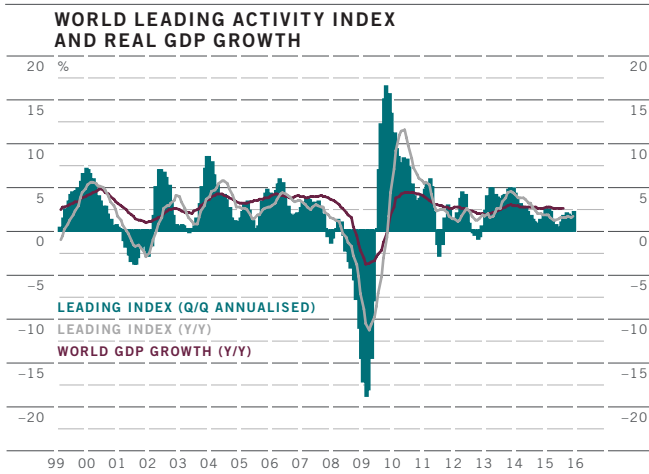
## Equity sector rotation and currency performance



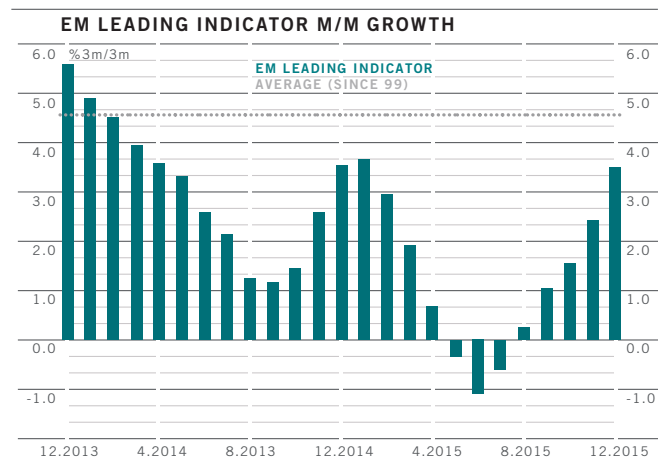
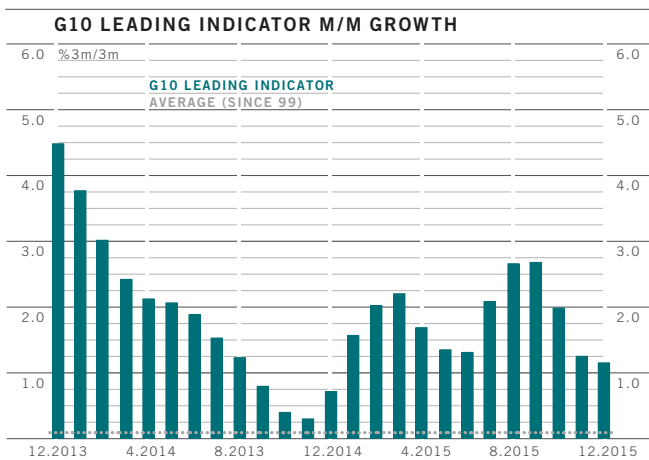
## Risk bias indicators



## Business cycle: World economic growth continues to build



## Economic momentum improving in emerging markets



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
	2015	2016	2015	2016	2015	12M			
US	0%	5%	-4%	3%	16.3	15.3	2.5	1.7	2.3%
EUROPE	-2%	5%	-3%	2%	15.0	14.2	1.6	1.1	3.8%
EMU	10%	7%	4%	3%	14.3	13.2	1.5	0.9	3.5%
SWITZERLAND	-7%	5%	-2%	2%	17.1	16.1	2.3	2.2	3.3%
UK	-18%	0%	-16%	0%	14.7	14.5	1.6	1.1	4.5%
JAPAN	14%	10%	-1%	2%	13.5	12.4	1.1	0.7	2.2%
EM	-3%	7%	-2%	6%	11.2	10.3	1.2	0.7	3.2%
NJA	4%	5%	-1%	6%	11.4	10.8	1.3	0.7	3.0%
GLOBAL	-1%	6%	-3%	3%	15.0	14.1	1.8	1.2	2.8%

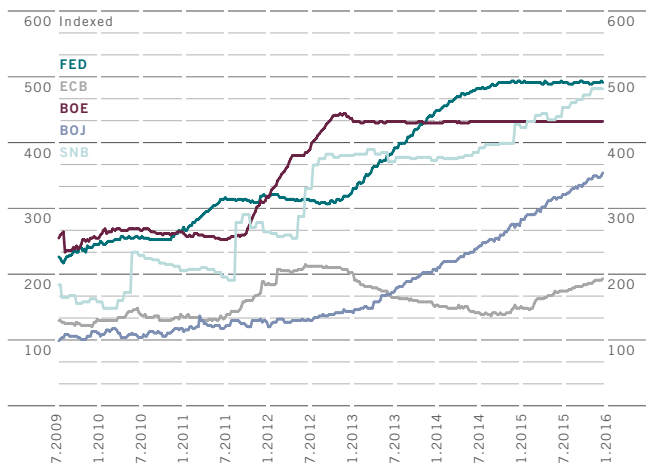
  

MSCI GLOBAL SECTORS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
	2015	2016	2015	2016	2015	12M			
ENERGY	-52%	-15%	-29%	-2%	17.1	19.3	1.0	0.6	4.8%
MATERIALS	-21%	3%	-9%	-1%	14.9	14.02	1.3	0.8	3.6%
INDUSTRIALS	2%	9%	0%	4%	15.4	14.1	2.2	0.9	2.6%
CONSUMER DISCRETIONARY	12%	14%	6%	6%	16.6	14.4	2.6	1.1	2.1%
CONSUMER STAPLES	-1%	7%	0%	4%	21.1	19.5	3.8	1.3	2.7%
HEALTH CARE	11%	9%	8%	7%	17.6	16.0	3.6	2.0	1.9%
FINANCIALS	10%	5%	6%	5%	10.9	10.4	1.0	1.5	3.6%
IT	6%	6%	4%	4%	16.1	14.8	3.0	2.1	1.7%
TELECOMS	8%	6%	4%	5%	15.1	14.3	2.0	1.3	4.3%
UTILITIES	10%	-5%	-1%	0%	13.3	13.8	1.4	0.9	4.1%
MARKET	-1%	6%	-3%	3%	15.0	14.1	1.8	1.2	2.8%

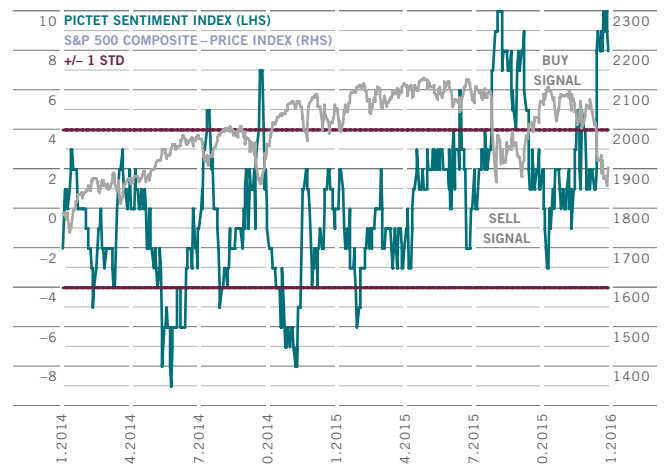
Liquidity: Fed ends QE and raises rates, but monetary stimulus continues elsewhere

Sentiment indicator shows 'buy' signal

#### SIZE OF CENTRAL BANKS' BALANCE SHEETS



#### PICTET SENTIMENT CYCLE INDEX



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

ing system. The Italian government's deal with the European Commission to securitise some of that debt and give it a state guarantee does not seem to be a permanent solution, in our view. Left unchecked, the problem could threaten the stability of the euro zone's banking system.

Japan's economic data is mixed, with a strong labour market coinciding with weak industrial production and exports. But the surprise BoJ deposit rate cut should help improve economic conditions over the course of 2016.

China's business climate is improving. Although its slowing economy is responsible for much of the downward pressure on commodity markets, we believe fears of a hard landing are overblown. Our leading indicator suggests a continued rebound from a trough in mid-2015. Construction activity and car sales are both witnessing a convincing recovery.

At least some of the pressure on financial markets in recent weeks may be attributed to a general tightening of **LIQUIDITY**, principally in the US. The Fed fulfilled its long heralded intention to start raising interest rates in December, giving added

momentum to tightening cycle that started in 2014 with the end of its quantitative easing programme. But conditions may be about to ease once more – at its January meeting, the Fed signalled that global market turmoil could potentially slow the pace of hikes.

Elsewhere, Chinese authorities are trying hard to counter any drop in the money supply by injecting funds into the economy at an unprecedented rate. This is being done principally to offset the deterioration of liquidity conditions in the US dollar money markets.

Meanwhile, Europe and Japan continue to ease monetary policy. And it is the ECB that seems to be enjoying the greatest success. The recent ECB Bank Lending Survey showed a strong recovery in loan making to companies, suggesting that the positive effects of quantitative easing were spreading from the household to the corporate sector.

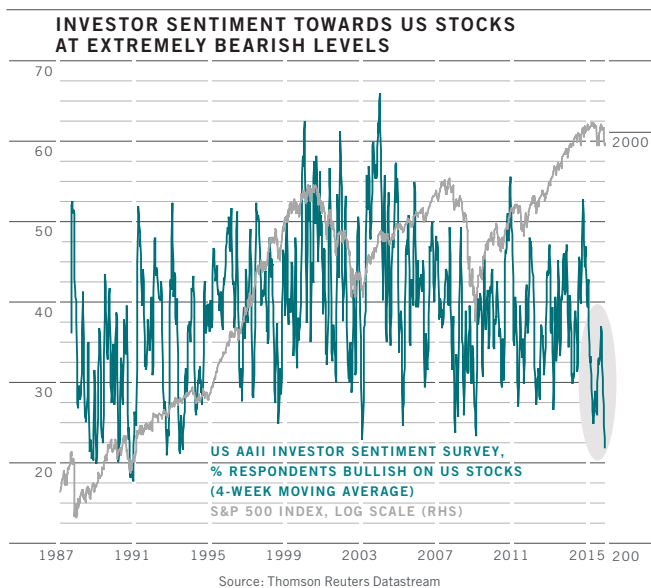
When it comes to **VALUATIONS**, equities remain much cheaper than most bonds. Though we continue to see more corporate earnings forecast downgrades than upgrades, equities are attractively-priced in the wake of the recent turmoil. Global stocks trade at a below-average 14 times expected 2016 earnings. Emerging markets offer the cheapest valuations – on a price-to-sales basis, de-

veloping world stocks are trading at a record low compared to their advanced world counterparts. By contrast, bonds saw a deterioration in relative valuation over the past month – developed market government bonds are trading at levels that are, by our calculations, more than one standard deviation above fair value.

Our **TECHNICAL** indicators show market breadth – the proportion of stocks that move higher relative to those whose prices are declining – falling across all regions with little remaining difference between developed and emerging markets. But for now, most equity regions and sectors are looking deeply oversold, suggesting a rebound is a possibility. Bearing testimony to this is a sharp drop in the proportion of US investors that are optimistic on the prospects for US stocks (see Region and Sector Allocation section).



## Preference for Europe and Japan maintained; taking a less dim view of US market



Europe and Japan remain our preferred equity markets in the developed world as these regions' ultra-loose monetary policies should boost both economic growth and corporate earnings. Emerging market stocks are also attractive.

Europe is our top pick as the region's economic recovery is proving resilient, thanks to the ECB's stimulus, robust private consumption and a weak euro, which is lifting exports. Aggressive ECB stimulus measures have been filtering through to the real economy and are boosting bank lending. The volume of money in circulation – as indicated by M1 money – is expanding at an annualised 11 per cent. Particularly encouraging is that demand for credit is also on the rise from businesses, which bodes well for investment spending.

Meanwhile, lower oil prices have increased consumers' spending power, and this has served to drive retail sales higher across Europe. Car sales, for instance, are up 17 per cent year on year. This encouraging economic picture suggests that corporate profits could rise by as much as 10 per cent in 2016, ahead of the 7 per cent increase the market is currently anticipating. It is also worth noting that euro zone company earnings

have lagged those of their US counterparts since 2007. While the US has seen profits rise 20 per cent over that time, the euro zone has seen earnings fall by the same magnitude. There is, then, plenty of scope for corporate Europe to catch up. What is more, euro zone stocks are attractively-valued. They are trading at a price-earnings ratio of 14.6 compared to 15.5 per cent for global stocks.

There are a number of risks on the horizon, however. Poland's new government is proposing policies that have triggered a credit rating downgrade from S&P, Spain is about to enter a period of political upheaval and there are growing concerns surrounding the solvency of a number of Italy's regional banks. The UK's looming referendum on EU membership is another investment risk for the region.

Japan's economy, meanwhile, is expected to continue to recover moderately after falling short of expectations in 2015, and this should prove supportive for stocks. Growth is set to gather speed, led by private consumption while corporate investment can be expected to rise steadily. In addition, falling oil prices will not only give companies room to raise wages but should also boost household spending power.

With Japanese companies forecast to turn in profit growth of 11 per cent

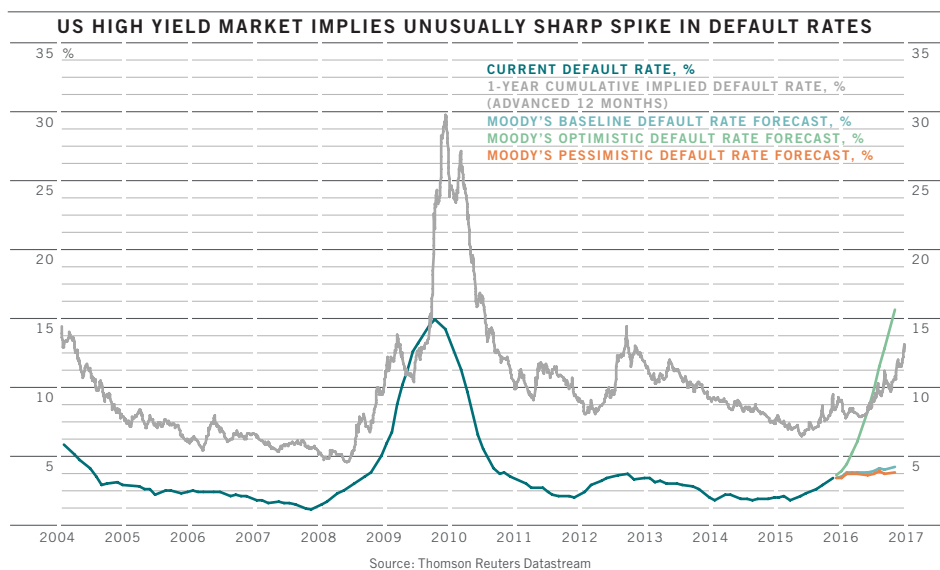
this year but their stocks trading at price-earnings ratio of less than 13, the market looks good value.

We also retain our overweight stance on emerging market stocks. There have been signs that economic growth is stabilising across the developing world and this sets the stage for a recovery in the earnings of emerging corporates. In the past four weeks, we have seen an improvement in macro-economic indicators throughout emerging markets, including in China and Brazil. Our proprietary leading indicator has been rising since June.

The prospect of a rate cut in China and a less hawkish Fed could also bring relief to emerging economies and allow equity markets to rally from their depressed levels. Valuations are particularly compelling: emerging stocks currently offer a 30 per cent discount to their developed counterparts on average. What is more, the ratio of corporate earnings forecasts cuts to increases is improving. We are turning less bearish on US stocks and have reduced our underweight to reflect our view that the export-sapping rise in the US dollar may soon run its course, and that the equity market may have reached a trough. With analyst estimates for earnings at low levels and investor sentiment towards US stocks the least bullish it has been since 1994 (see chart), we think the scope for a further decline in the market is limited.

When it comes to sectors, we have cut our exposure to financials as we believe the policies implemented to address the solvency of Italy's regional banks are inadequate. Meanwhile, consumer discretionary remains one of our preferred sectors. Although valuations are not spectacularly cheap, rising wages and low inflation will increase disposable income and boost consumer spending, benefiting companies in the sector.

## Cool on government bonds, attracted to high-yield



**W**e headed into January convinced that developed government bonds were expensive. The market rally that has unfolded over the past month has simply reinforced that belief. Yields on sovereign debt are far more likely to rise than fall.

With investors having snapped up US Treasuries and German Bunds as enthusiastically as they sold equities in January, global government bonds are almost as expensive as they have ever been. On average, a 10-year bond issued by a developed market sovereign now yields less than 1.4 per cent – just 15 basis points above the all-time low hit a year ago. Put another way, government bonds are trading at a level that are some 1.3 standard deviations above what our model suggests is fair value. This looks difficult to justify. Not only is the Fed tightening monetary policy, albeit gradually, but core inflation is also on the rise. What is more, even if the ECB further loosens the monetary reins, its actions would most likely benefit longer-dated debt or corporate bonds.

At the other end of the valuation spectrum is US high-yield debt. Here,

the sell-off that has largely been induced by a sharp fall in oil prices has pushed yields to levels more typically seen during recessions. The extra yield now offered by US high yield bonds over US Treasuries is just below 800 basis points, implying a spike in bond default rates from 3.3 per cent to over 13 per cent over the next 12 months (see chart).

Such a weakening in the credit profile of high-yield issuers is improbable considering the US economy remains on course to expand by some 2.4 per cent this year, fuelled by a pick-up in consumer spending. Also, high-yield bonds offer a good insurance against an unexpected pick up in the pace of US interest rate hikes. Because the asset class's duration is lower than that of other fixed income securities, it has typically fared well when monetary policy has been tightened.

For these reasons, we increased our overweight to US high yield debt. Valuations are attractive for local currency emerging market bonds, too. In fact, the asset class is the cheapest on our scorecard. The market had a torrid 2015, ending down some 15 per cent – its weakest year since the launch of the first local bond in-

dex. This year should see a turnaround. If, as we envisage, the US dollar's appreciation slows during 2016, then the 7 per cent yield current offered by local currency bonds should more than offset any further decline in emerging market currencies. According to our model, emerging currencies are trading at about three standard deviations below their fair value. Consequently, we retain our overweight stance on emerging market local currency debt.

In the currency market, we expect the US dollar to trade within a narrow range over the short term. Still, we remain long the euro versus the US dollar although the exchange rate is nearing our medium-term target of USD1.10. With the Fed unlikely to raise rates at a rapid pace and with surveys showing that a majority of investors are overweight the US dollar, the scope for further gains in the greenback, which our models suggest is overvalued by some margin, look limited.

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Each month, the PSU sets a broad policy stance based on its analysis of:

## BUSINESS CYCLE

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Proprietary leading indicators, inflation

## LIQUIDITY

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Monetary policy, credit/money variables

## VALUATION

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Equity risk premium, yield gap, historical earnings multiples

## TECHNICALS

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Pictet sentiment index (investors' surveys, tactical indicators)

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