PICTET
1805
Asset Management

TACTICAL ALLOCATION
MONTHLY UPDATE

June 2016 BAROMETER

Dialling down equities

GLOBAL ASSET CLASSES

We reduce equities to neutral and raise our exposure to cash as economic growth has slowed and the outlook for US monetary policy remains uncertain.

EQUITY REGIONS AND STYLES

We downgrade emerging market stocks to neutral as China's economic revival looks to be losing steam.

EQUITY SECTORS

We maintain a cyclical tilt via an overweight in materials and consumer discretionary stocks.

FIXED INCOME

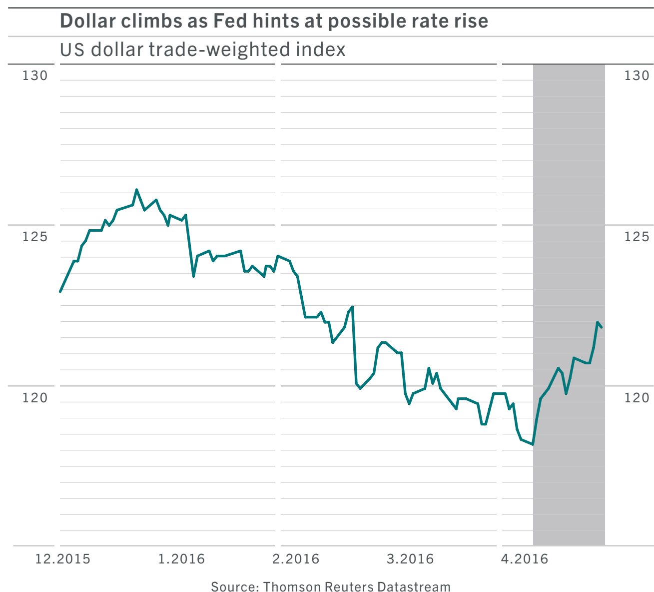
We remain overweight US government bonds and US high yield debt.

	Underweight —		Neutral 0		Overweight +	Monthly change <<<<	>>>>
ASSET CLASSES			Equities			<	
		Bonds					
				Cash			>
EQUITIES		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		
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.

Dollar rallies on US rate hike expectations; stocks flat



Equities ended the month broadly flat in local currency terms as strong signals from the US economy were offset by evidence of slowing growth in China. The dollar rose more than 2 per cent against a basket of major currencies as expectations grew that the US Federal Reserve would raise interest rates in June or July. Futures markets ended the month pricing in a 50 per cent chance of a US rate hike in July.

Crude oil prices rose nearly 5 per cent, briefly hitting the USD50 a barrel mark for the first time this year, and bringing this year's gains to more than 20 per cent, as concerns grew about supply outages in Canada and Nigeria.

The prospect of a tightening of US monetary policy and a rise in the dollar hit emerging market equities, which shed around 5 per cent in US dollar terms.

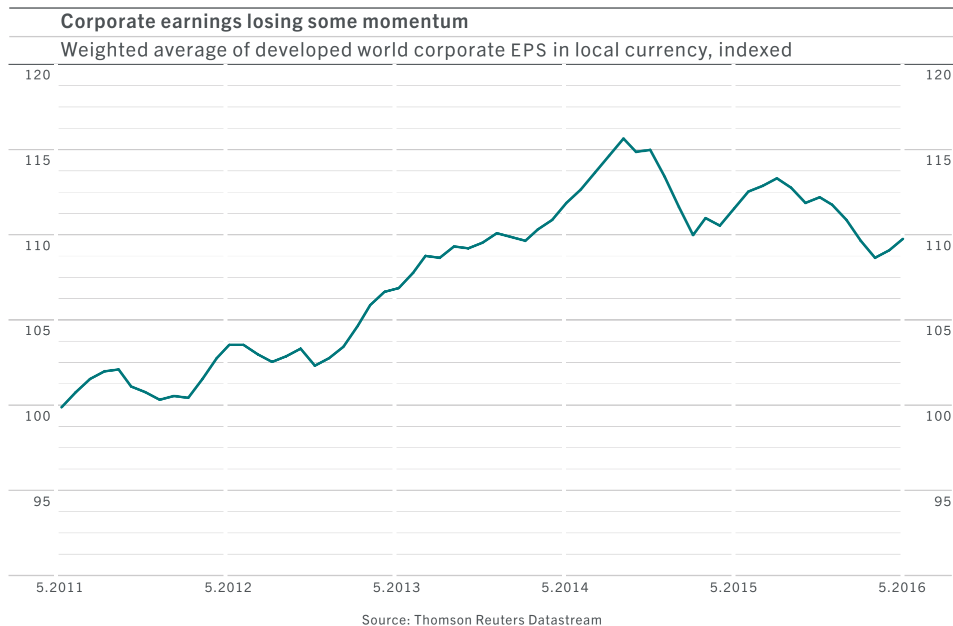
In developed stock markets, Japanese equities fell amid mounting evidence that the Bank of Japan's monetary stimulus is failing to boost growth. The sell-off was held in check, however, as several Japanese companies increased share buybacks to protect their cash piles from the effect of negative interest rates.

Energy and material stocks were the worst performing sectors in May, as worries persisted over the effect of a sharp fall in business investment following a recent decline in oil prices. Technology stocks gained more than 3 per cent, pushing this year's performance into positive territory. US financials also saw strong gains as investors bet a higher US cost of borrowing would boost the profitability of banks.

In the currency markets, emerging market currencies fell against the dollar, with those from countries that are reliant on external capital hardest hit; the South African rand and the Turkish lira were among the major casualties of the sell-off. Meanwhile, the Chinese yuan was fixed at the lowest level in five years, tracking a weaker market price in the face of a dollar rally.

Government bonds ended mostly lower following a rally earlier in the month that took world bond yields, measured by JP Morgan, to a record low of 1.08 per cent. In the US, the yields on short-term US Treasuries – most sensitive to changes in interest rate expectations – hit 10-week highs.

Equities downgraded to neutral as risks rise



Source: Thomson Reuters Datastream

Economic momentum is slowing worldwide at a time when there is political upheaval in Europe and growing uncertainty over the direction of US and Chinese monetary policy.

A possible interest rate rise in the US in the summer, an economic slowdown in China and a UK referendum on European Union membership are among the risks confronting investors.

Against this volatile backdrop, we have cut our equity exposure to neutral from overweight, and raise cash to overweight. We upgrade gold, a defensive asset that tends to do well in volatile times, to overweight from neutral. We remain underweight bonds.

Our BUSINESS CYCLE indicators show US economic growth is slowing due to an export-sapping rise in the US dollar. Retail sales rebounded in April while the housing market is also recovering, with last month's new home sales staging their biggest monthly jump since 1992.

Looking ahead, we expect consumption to remain the main engine of economic expansion in the coming months, as lower energy prices and tightening labour market conditions should boost household spending power.

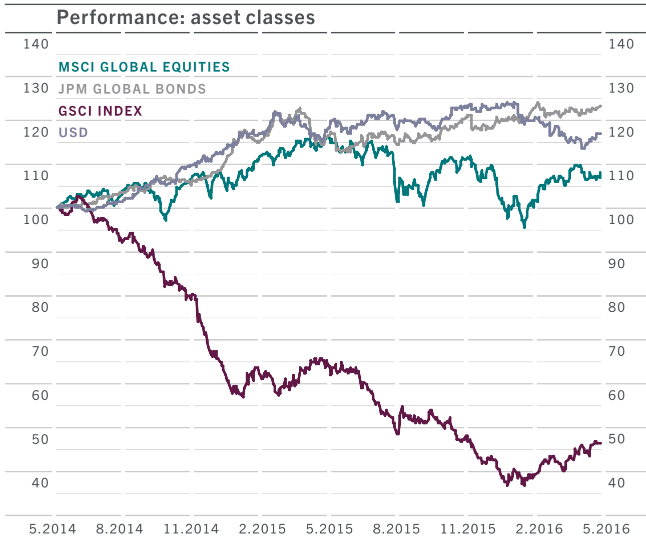
All this is not to say that a US interest rate hike is certain to materialise in the summer. Minutes from the US Federal Reserve's April meeting showed most officials consider it appropriate to raise rates in June if data continues to point to an improvement in growth in the second quarter. Yet while the central bank is clearly inclined to raise rates sooner rather than later, the exact timing of any hike will hinge on evidence of inflationary pressures in the labour market.

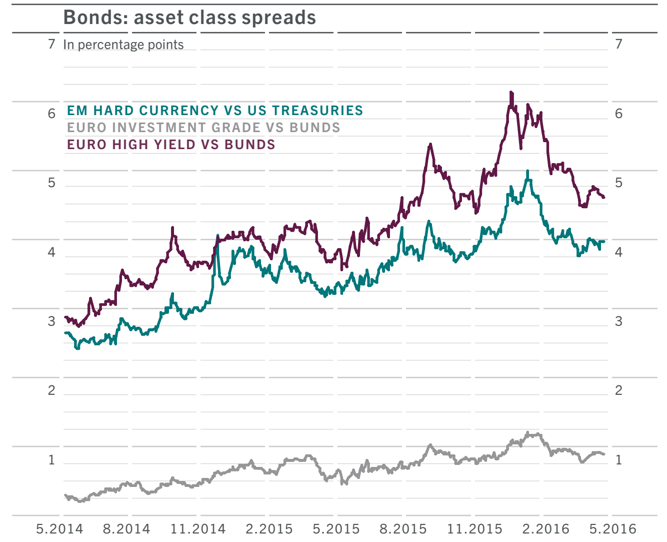
The euro zone is enjoying a modest economic recovery, thanks to the European Central Bank's monetary stimulus. Germany is showing particular strength by more than doubling its growth rate in the first quarter, with record-low unemployment, low interest rates and higher wages translating into higher household spending. However, the outlook for the rest of the single currency bloc is more uncertain as external demand is likely to remain lacklustre, while consumer and business surveys indicate personal spending and industrial activity may slow down.

Economic growth in Japan deteriorated further over the month as both domestic and external demand was sluggish. While the world's third largest economy avoided a recession in the first quarter, the outlook for business investment and consumer spending is bleak, despite the Bank of Japan's efforts to stimulate growth with negative interest rates and large asset purchases. Prime Minister Shinzo Abe has announced a supplementary budget to help reconstruction after a recent earthquake. However, we believe Japan needs a coordinated policy initiative of monetary and fiscal stimulus to kick-start its economy as half-hearted measures run the risk of destabilising the economy.

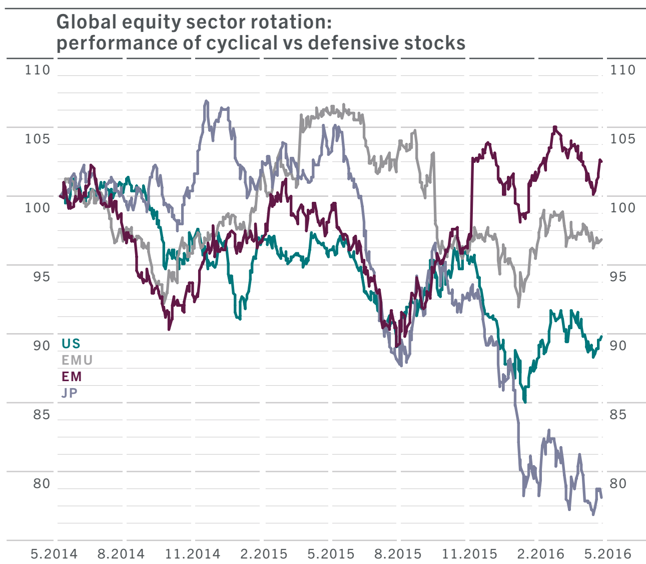
In China, economic activity is moderating after a strong January-March period. Credit growth slowed in April as the authorities sought to avoid a bubble

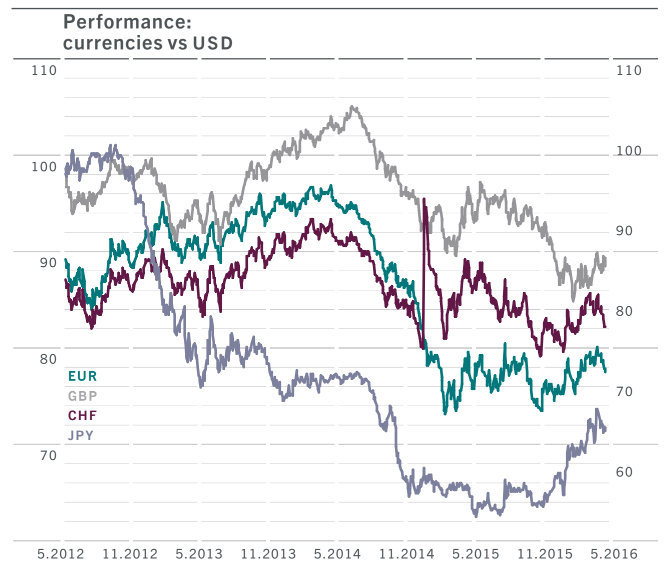
Major asset classes





Equity sector rotation and currency performance





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

Risk bias indicators

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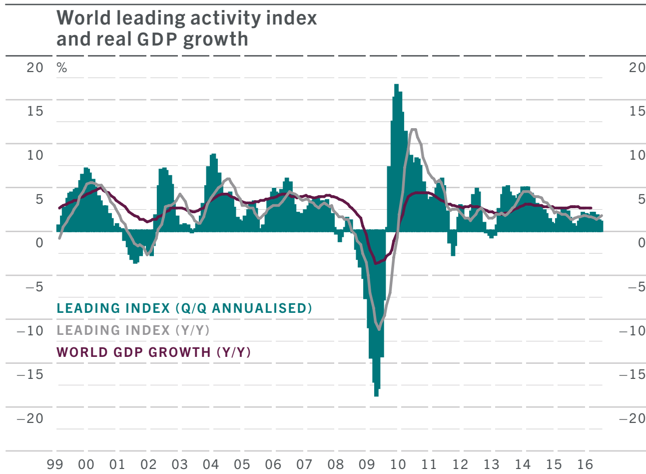
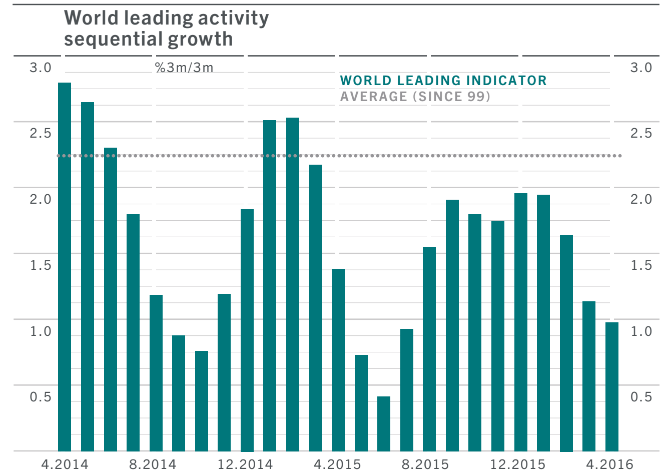
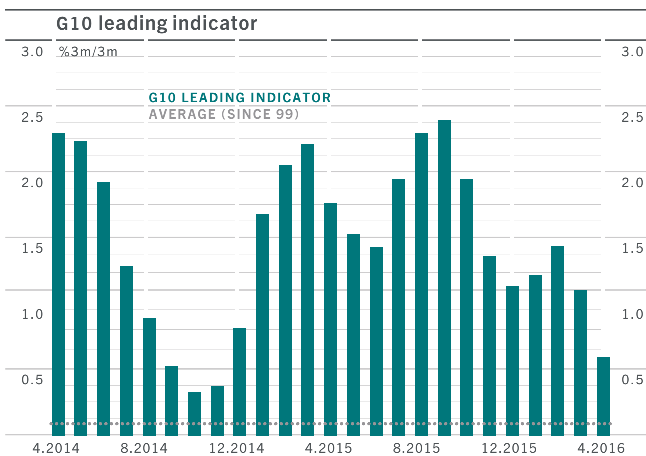
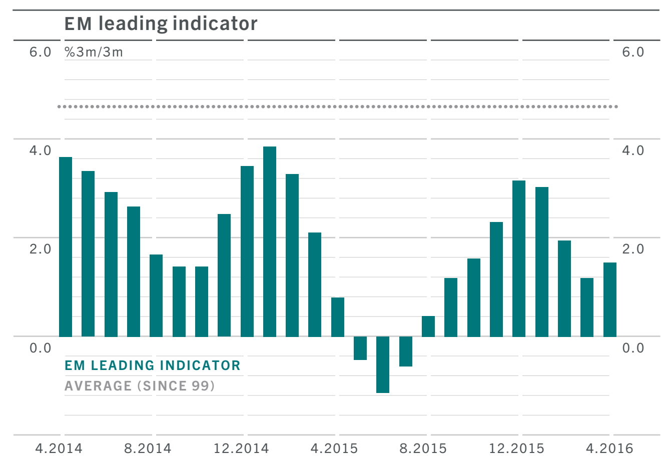
Business cycle: World economic growth remains moderate





Economic momentum eases slightly





Source: Pictet Asset Management,
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Valuation: Equity markets and sectors

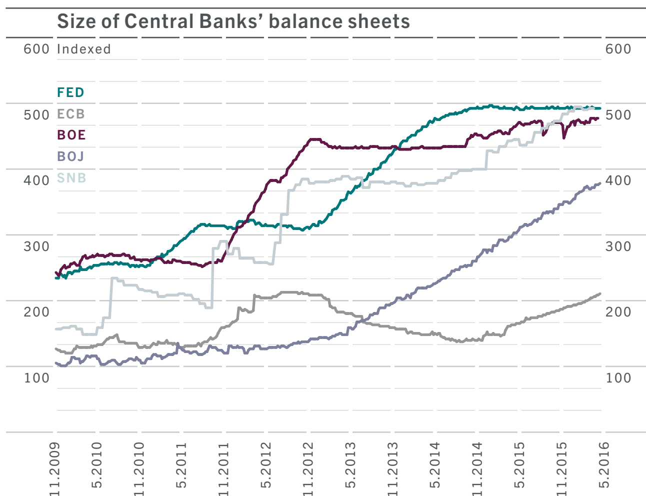
Countries and sectors

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%	17.5	16.5	2.6	1.8	2.2%
EUROPE	0%	14%	-1%	6%	15.5	14.7	1.6	1.2	3.8%
EMU	3%	13%	0%	4%	14.3	13.5	1.4	0.9	3.7%
SWITZERLAND	0%	12%	1%	4%	17.7	16.9	2.4	2.2	3.4%
UK	-6%	18%	-3%	8%	16.7	15.6	1.7	1.2	4.3%
JAPAN	18%	7%	0%	3%	13.2	13.0	1.1	0.7	2.4%
EM	8%	13%	4%	10%	11.8	11.2	1.3	0.7	2.9%
NJA	3%	11%	4%	9%	12.1	11.6	1.2	0.7	2.9%
GLOBAL	**2%**	**13%**	**1%**	**6%**	**15.9**	**15.1**	**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%	96%	-12%	21%	35.7	25.5	1.3	0.9	3.8%
MATERIALS	6%	18%	-5%	5%	17.8	16.4	1.6	1.0	2.5%
INDUSTRIALS	12%	10%	2%	4%	16.0	15.3	2.3	0.9	2.6%
CONSUMER DISCRETIONARY	13%	12%	5%	5%	15.3	14.6	2.4	1.0	2.2%
CONSUMER STAPLES	5%	10%	3%	5%	21.2	20.2	4.0	1.3	2.6%
HEALTH CARE	7%	11%	8%	6%	16.5	15.8	3.4	1.9	2.1%
FINANCIALS	0%	9%	3%	5%	11.9	11.4	1.0	1.5	3.7%
IT	2%	13%	2%	5%	16.7	15.7	3.0	2.2	1.7%
TELECOMS	7%	9%	4%	3%	15.2	14.8	2.0	1.3	4.2%
UTILITIES	-3%	4%	-1%	2%	14.8	14.6	1.4	1.0	4.0%

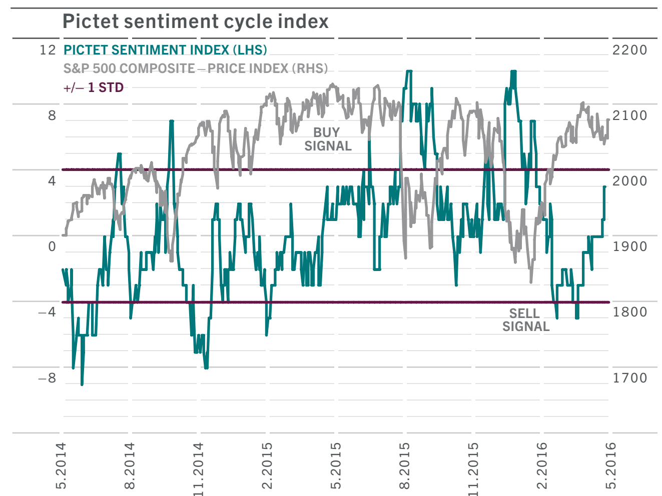
Liquidity: Fed begins to hike rates, but stimulus provided by other central banks

Size of Central Banks' balance sheets



Sentiment indicator in neutral territory

Pictet sentiment cycle index



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

after a record expansion in loan-making activity, while consumer spending and industrial production grew at a slower pace.

In the rest of emerging markets, growth is improving on balance. Falling inflationary pressures may prompt some central banks to either reverse their tight monetary policy stance or cut interest rates to support their economies.

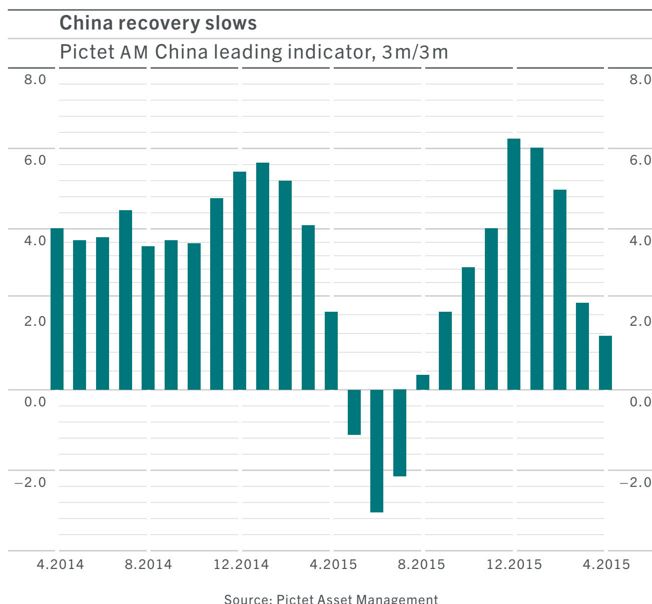
Our LIQUIDITY readings have turned neutral after having been in positive territory for the past three months. Growing expectations that the Fed will hike interest rates in the next few months, a steady rise in US inflationary pressures and China's adoption of stricter controls aimed at limiting capital outflows have led to a draining of liquidity worldwide.

Our VALUATION signals show equities continue to be attractive relative to bonds. Still, there remains a persistently wide dispersion in valuation across both regions and industries. US stocks are expensive compared to their developed and emerging counterparts. The 12-month price earnings ratio of US stocks stands at 17, which is 20 per cent above the reading suggested by our fair value model. Moreover, the gap between the profitability of US and European companies is at its widest level on record. To us, this suggests the US corporate earnings cycle is maturing and that European firms' profits could soon stage a recovery.

While, overall, corporate earnings growth remains sluggish (see chart on p2), company quarterly results largely surpassed expectations in most parts of the world, although Japan bucked that trend.

Our TECHNICAL indicators suggest taking a neutral stance on riskier asset classes. The failure of cyclical stocks to build on their recent rally is a sign that investors currently lack conviction in equities. Meanwhile, the put-call ratio – the trading volume of put options to call options – shows that demand for protection against a market decline is rising. Another reason to be cautious on equities comes in the form of seasonal factors – there is a large body of evidence showing riskier asset classes rarely do well in the summer months.

Emerging markets downgraded to neutral, staying long Europe and Japan



Source: Pictet Asset Management

In our regional equity allocation, we trim our emerging market exposure to neutral on concerns that the recent revival in the Chinese economy might prove short-lived.

Our leading indicators show that economic activity across China has cooled (see chart), which is all the more worrying as the slowdown comes at a time when authorities appear to be draining some of the liquidity they provided earlier in the year.

Annual growth in both retail sales and industrial production fell back considerably in April (from 9.7 per cent to 9.3 per cent and from 6.8 per cent to 6 per cent respectively). Investment in the manufacturing sector, meanwhile, eased up to a yearly pace of 6 per cent.

The investment case for emerging market equity has weakened in other ways. The asset class's appeal had stemmed from a weaker US dollar – which provides a boost to commodities and helps ease corporations' debt servicing costs – as well as attractive valuations.

Even though developing world stocks still look inexpensive relative to other equity markets – on a price-to-earnings basis, they trade at a 25 per cent discount to the MSCI World Index – the dollar has edged higher on speculation that the Fed may raise interest rates as early as next month. At the same time, recent shifts in investor positioning suggest there is limited scope for further gains in emerging market equities. The recent rally was accompanied by a surge in investment inflows from foreigners – last month alone saw some USD26 billion of inflows. The likelihood of seeing similar inflows over the summer looks slim.

Europe and Japan remain our favourite equity markets in the developed world because of these regions' ultra-loose monetary policies, which should boost economic growth and corporate earnings. Although our leading indicators show that growth momentum might soon ease in Europe, data has remained encouraging on the whole. The Citigroup Economic Surprise Index for Europe – which tracks the extent to which data surpasses or trails consensus economists' forecasts – has moved into positive territory for the first time since January, in contrast with the US, where the gauge stands at its lowest level since late February.

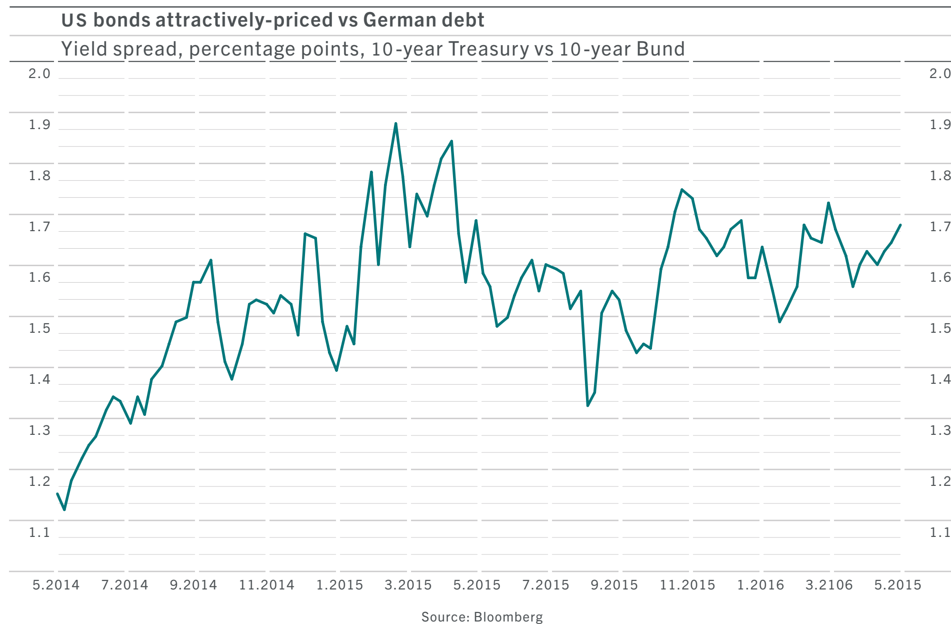
Even though corporate earnings growth has been lacklustre globally, a number of factors leave European and Japanese corporations better positioned to see a recovery in profits. Companies in Europe and Japan face less pressure on profit margins than in the US, where margins are at record levels. Euro zone company earnings, in particular, have lagged those of their US counterparts over the past several years and this leaves plenty of scope for corporate Europe to catch up. Earnings among European firms have trailed US earnings by some 60 per cent since 2008 in local currency terms.

Meanwhile, corporate reform is bearing fruit in Japan, where 282 companies listed on the Tokyo stock exchange have announced share buyback plans totalling USD36 billion. That trend is set to continue, we believe, benefiting shareholders. With both Japanese and European equity markets having underperformed the US in recent weeks, they are now trading at very cheap valuations.

When it comes to sectors, we continue to prefer cyclical stocks that are inexpensive such as consumer discretionary and technology companies, which are set to benefit from a rise in consumer spending. Telecom companies also stand out as very attractively valued. What is more, the sector should also benefit from industry consolidation and an easing of regulatory pressures.

Consumer staples, by contrast, trade at expensive levels and companies with exposure to emerging markets could be affected by the loss of economic momentum there. Utilities are also unattractive. Not only are they susceptible to increased regulation but such defensive, bond-like, stocks also tend to suffer disproportionately when interest rates rise.

Maintaining overweight in US government bonds



Developed world bond markets have wasted little time in factoring in the prospect of a summer US interest rate hike, with US futures contracts now attaching more than a 50 per cent probability to that outcome following the publication of the minutes to the Fed's April meeting.

In our view, however, the odds of a hike being delivered in the next two months are slightly longer than US bond yields imply. The Fed is unlikely to move in June ahead of the UK referendum on EU membership, while US economic data – which has improved since the Fed last hiked rates in December but is still showing weak spots – do not present a particularly compelling case for a tightening of monetary policy over the very near term.

With this in mind, we have decided to extend the duration of our fixed income portfolio, increasing our exposure to longer-dated US government bonds, where yields have risen to what we believe are unjustifiably high levels.

The overweight stance on US government bonds is maintained in tandem with an underweight in euro zone government debt. The yield gap between the two asset classes is some 170 basis points – less than 20 basis points from the peak hit in May last year - which is difficult to justify at a time when the US and euro zone economies are expanding at almost exactly the same rate in nominal terms.

In corporate bond markets, meanwhile, we believe technical and seasonal factors are beginning to turn in favour of US investment grade debt – history shows the asset class tends to fare better than riskier debt during the summer months, and the indicators we monitor suggest that pattern should also hold this year. We consequently raise US investment grade bonds to neutral and reduce exposure to US high yield to a single overweight.

Emerging market US dollar denominated bonds are also attractive. From a technical standpoint, the picture is especially positive as the amount of emerging market sovereign bond redemptions and coupon payments has recently risen above the volume of new debt issues. Since April, the net supply of emerging market sovereign bond debt has been negative. What is more, the spread offered by emerging market dollar denominated bonds is hovering at around 420 basis points, some 60 basis points above the five-year average.

Elsewhere, we retain a neutral stance on emerging market local currency debt. Although the asset class offers a considerable yield pick-up over developed world debt, we believe emerging market currencies could see renewed volatility ahead of the next two rate setting meetings in the US.

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Issued June 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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