

March 2016 **BAROMETER**

Equities underestimate
recovery potential

GLOBAL ASSET CLASSES

We stick to our overweight stance on equities and remain underweight bonds as economic growth is stronger than asset class valuations imply.

EQUITY REGIONS AND STYLES

Improving economic conditions in China bode well for emerging market stocks; we also favour Japan and Europe over the US.

EQUITY SECTORS

We like consumer discretionary and technology companies, which stand to benefit from a rise in consumer spending.

FIXED INCOME

We remain overweight US high-yield debt and emerging market local currency bonds on valuation grounds.

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

Equities flat as safe-haven assets outperform

UK EU exit fears weigh on sterling

GBP/USD spot rate



Source: Thomson Reuters Datastream

Equities ended a volatile month flat but underperformed bonds as investors grew concerned about the impact of negative interest rates on the banking sector. Gold rose over 10 per cent while the Japanese yen and most developed market government bonds gained as risk-averse investors sought safe-haven assets. Oil ended the month down around 3 per cent, despite a mid-month bounce after Russia and OPEC agreed to freeze production, as concerns about oversupply persisted.

Within equity markets, financial stocks were the biggest losers. Concerns are growing that sub-zero interest rates, which are now in place in Japan and many parts of Europe, could squeeze bank profits at a time when lenders' net interest margins are already at record lows.

European equities were a weak spot as data pointing to a dip in growth and an easing of inflation darkened the outlook for corporate profits in the region.

Emerging stocks ended the month slightly lower, although the benchmark MSCI EM index hit a six-week high during the month as data pointed to stabilisation in emerging economies. Also lending support to the

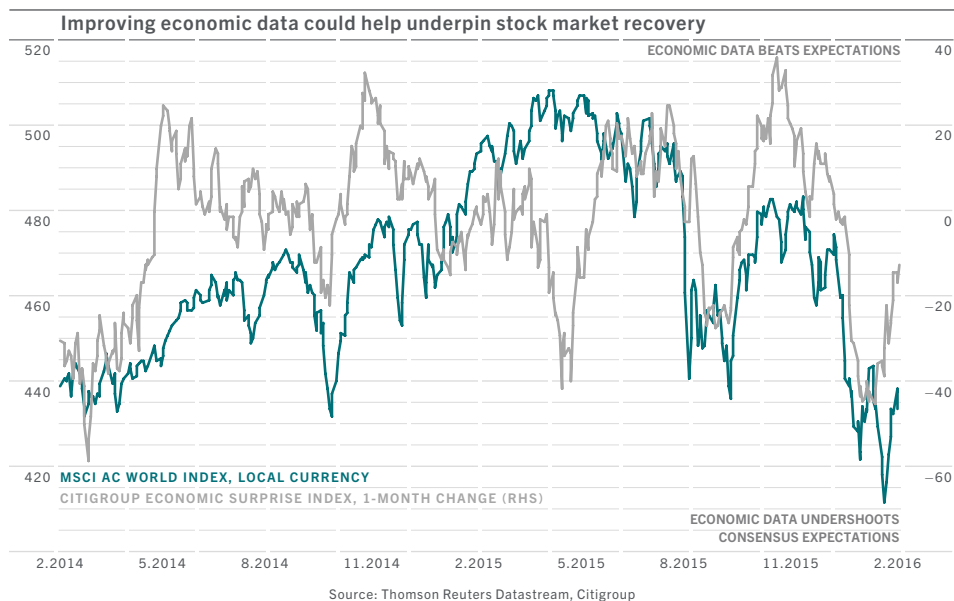
asset class were signs that China may deliver more monetary and fiscal stimulus to support its recovery.

In fixed income, US high-yield bonds extended their drop, led by energy and mining sectors, as concerns over weak oil prices and uncertainty over the path of US interest rates encouraged investors to shun risky debt. Japanese government bonds rose sharply, with the yield on benchmark 10-year debt briefly hitting a record low of minus 0.055 per cent after the Bank of Japan (BoJ) surprised investors late January by adopting negative interest rates. Yields on US Treasuries also fell, with the yield on the 10-year note threatening to break below 1.7 per cent, a level last breached some 12 months ago.

In the currency markets, sterling saw a sharp decline as the UK government confirmed it would hold a referendum on the country's membership of the 28-member European Union. Sterling fell to a seven-year low against the US dollar as investors priced in an increased risk of the UK's exit from the bloc.

The Japanese yen was the best performer, rising more than 7 per cent as the currency drew safe-haven bids.

Riskier asset classes remain attractive



Investor sentiment remains fragile thanks to some uninspiring economic data from the US, Europe and Japan. Some market gauges already imply the US is heading into recession: US high-yield bonds and Treasuries put the chances of a slump at about 7 in 10, according to our calculations.

We believe a US recession is off the cards – our central scenario remains one of continued, albeit slower, growth, underpinned by a steady improvement in economic conditions in China. And though the US Federal Reserve threatens to provoke more market disruption if it hikes interest rates further,

other central banks are likely to be mindful of the fragility of their own economies and act accordingly by loosening the monetary reins.

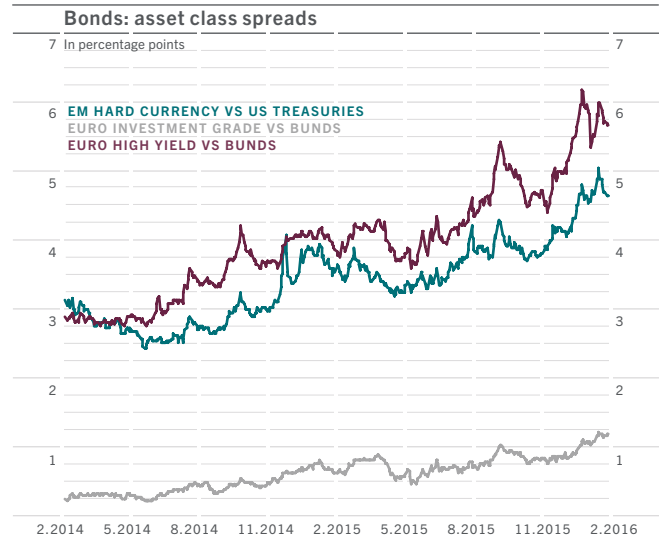
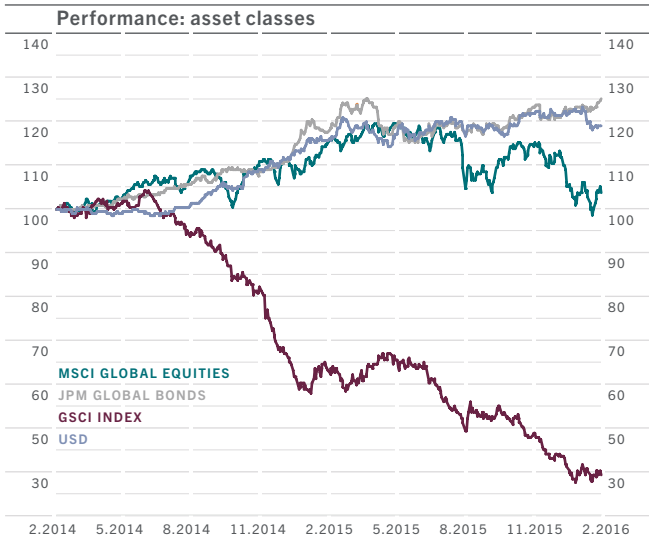
As a result, we are maintaining our overweight in stocks and our underweight in bonds. Our proprietary **BUSINESS CYCLE** indicators point to modest growth in both developed and emerging markets with the US and China looking most likely to deliver positive surprises.

In the US, economic growth remains robust but has eased due to the drag on exports from a strong US dollar and weakening demand overseas. A weak energy sector has also hampered economic performance. But American consumers, traditionally the main economic motor, remain in good shape as highlighted by strong retail sales, reflecting the boost to purchasing power from low energy prices as well as accelerating wage growth. We expect private con-

sumption to grow at yearly clip of about 3 per cent, helping the US economy expand at just under 2.5 per cent this year.

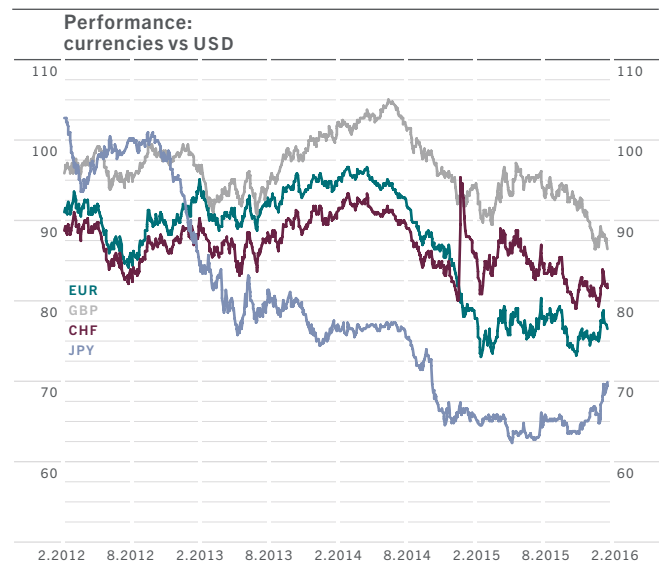
Similarly in Europe, private consumption continues to drive the region's economic recovery which is continuing, albeit at a more moderate pace than in the US. Low oil prices and a stronger labour market are likely to continue to support consumer-led growth for now. However, industrial production saw significant declines late in 2015 and German exports have weakened, reflecting

Major asset classes



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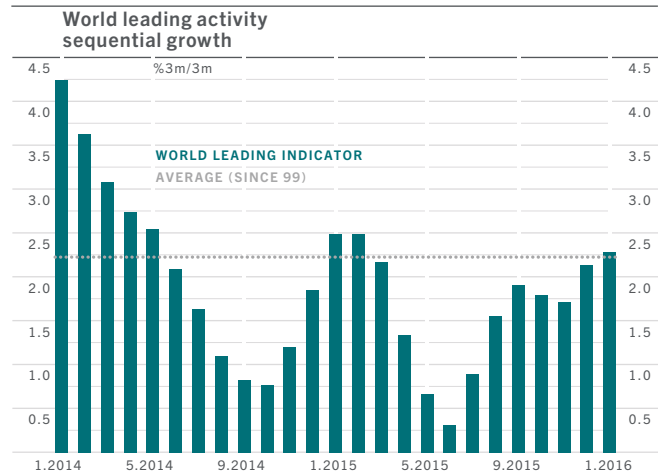
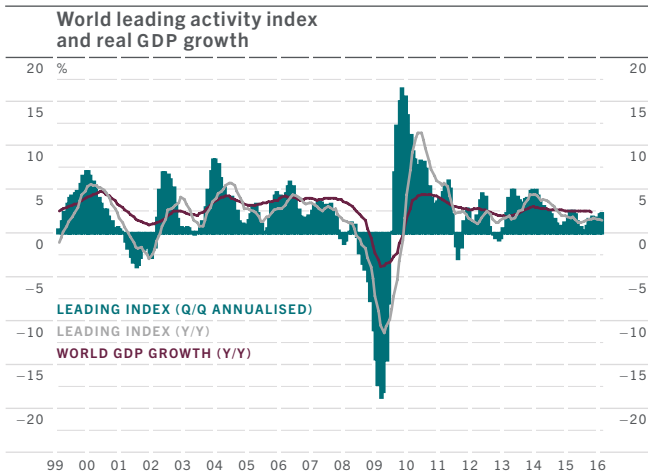
Equity sector rotation and currency performance



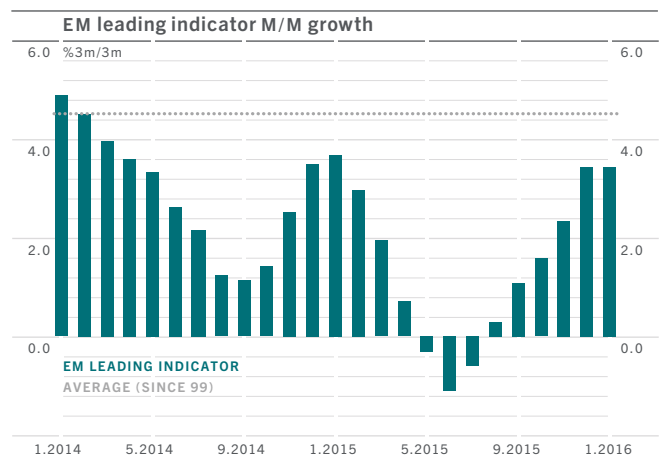
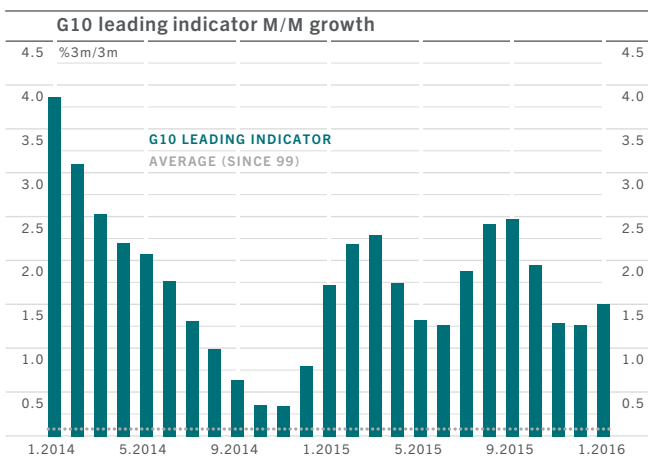
Risk bias indicators

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

Business cycle: World economic growth continues to build



Economic momentum in G10 picks up further; emerging markets show improvement



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

Valuation: Equity markets and sectors

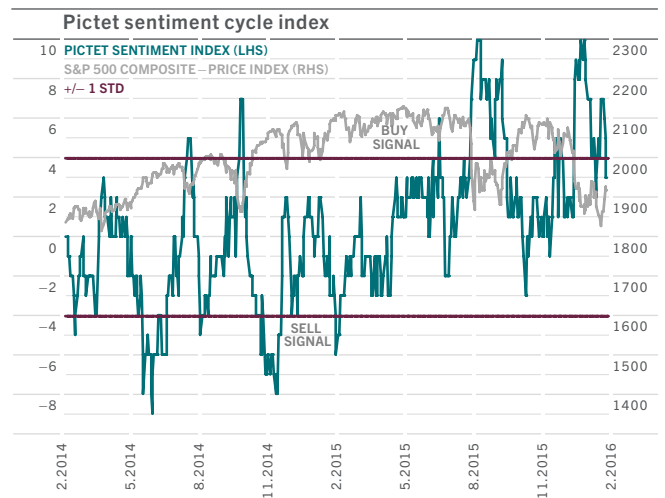
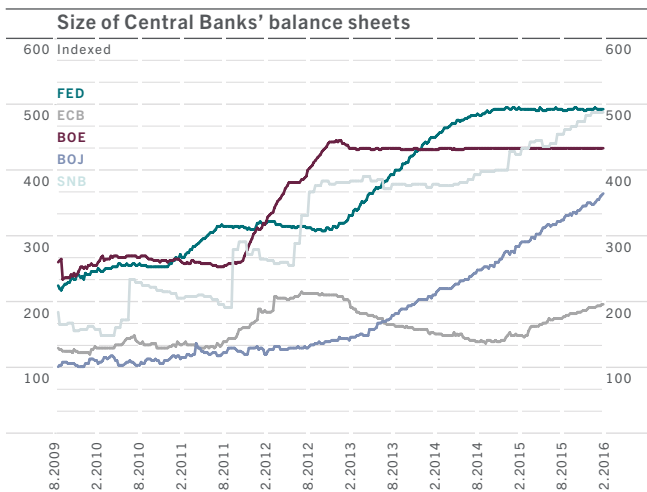
Countries and sectors											
MSCI REGIONS	EPS GROWTH		SALES GROWTH		PE		PB		P/SALES		DY
	2015	2016	2015	2016	2015	12M	2015E	2015E	2015E	2015E	
US	0%	3%	-4%	2%	16.5	15.6	2.5	1.7	2.3%		
EUROPE	-3%	3%	-3%	0%	14.0	12.9	1.6	1.1	3.9%		
EMU	8%	6%	3%	2%	16.7	15.9	1.4	0.9	3.6%		
SWITZERLAND	-9%	3%	-3%	2%	14.7	14.8	2.3	2.1	3.4%		
UK	-15%	-3%	-14%	-3%	14.7	12.0	1.6	1.1	4.6%		
JAPAN	9%	13%	-2%	2%	13.5	12.0	1.1	0.7	2.3%		
EM	-5%	4%	-4%	5%	11.8	11.2	1.3	0.7	3.1%		
NJA	1%	4%	-11%	6%	15.4	14.5	1.3	0.7	3.0%		
GLOBAL	-2%	4%	-4%	2%	14.6	14.0	1.8	1.3	2.8%		

MSCI REGIONS	EPS GROWTH		SALES GROWTH		PE		PB		P/SALES		DY
	2015	2016	2015	2016	2015	12M	2015E	2015E	2015E	2015E	
ENERGY	-56%	-31%	-30%	-8%	19.1	24.6	1.1	0.7	4.6%		
MATERIALS	-21%	-3%	-10%	-3%	16.0	15.8	1.4	0.9	3.3%		
INDUSTRIALS	1%	8%	0%	3%	16.3	14.9	2.3	0.9	2.5%		
CONSUMER DISCRETIONARY	11%	12%	5%	5%	16.7	14.7	2.6	1.1	2.1%		
CONSUMER STAPLES	-2%	5%	-1%	3%	21.9	20.4	4.0	1.3	2.6%		
HEALTH CARE	10%	8%	7%	8%	17.1	15.6	3.5	1.9	2.0%		
FINANCIALS	8%	4%	5%	4%	10.9	10.4	1.0	1.5	3.7%		
IT	3%	4%	1%	3%	16.3	15.1	2.9	2.1	1.7%		
TELECOMS	6%	7%	3%	4%	15.7	14.6	2.1	1.3	4.1%		
UTILITIES	9%	-4%	-2%	1%	13.9	14.4	1.5	0.9	4.0%		

BAROMETER
MARCH 2016

Liquidity: FED ends QE but monetary stimulus continues elsewhere

Sentiment indicator shifts to neutral



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

anaemic demand in overseas markets. Japan, meanwhile, has seen growth slow on weaker domestic and external demand. Retail sales have disappointed and we expect additional monetary easing to follow in consequence.

In emerging markets, we are encouraged by growing evidence of stabilisation in China, where industrial production has stopped falling; our proprietary leading indicator continues to suggest a return to health, and points to an economic expansion of some 6.7 per cent this year. Much of the recent improvement can be attributed to expansive monetary and fiscal policy, which has boosted the real estate sector and made exports more competitive. Other Asian emerging markets have also seen growth momentum sustained by easy monetary and fiscal policies while Latin America, we believe, is now due a recovery, having endured the worst of the impact from falling commodity prices.

Our **LIQUIDITY** readings have improved across the board because

decelerating growth has prompted some central banks to loosen the monetary reins. Europe and Japan are venturing further along the accommodative track, pursuing quantitative easing and low rates to boost money supply. A recent decline in growth suggests they could loosen the monetary bonds yet further. We believe that policy meetings in March could see aggressive and radical action such as a new programme to buy more fixed income assets from the European Central Bank (ECB), for example. China may also do more to boost money supply. Indeed, Chinese authorities' willingness to underpin growth was demonstrated at the very end of the month with a further 50 basis point cut to banks' reserve ratio requirement. The move – which takes the rate to 16.5 per cent – amounts to a liquidity boost equivalent to approximately 1 per cent of China's GDP. In the US, meanwhile, credit to households and businesses and the volume of money supply are growing at a yearly rate of 10 per cent and 6 per cent respectively. Still, the risk in the US is that of a badly-timed withdrawal of monetary stimulus, which could have worrying repercussions worldwide.

Our **VALUATION** indicators suggest riskier assets still look cheap notwithstanding a moderate market recovery in recent weeks. The equity risk premium for developed market stocks has risen back above 5 per cent, 100 basis points higher than the long-term average.¹ This suggests equities could gain

a further 20 per cent. In emerging markets, China boasts the most alluring valuations while financials are currently the cheapest equities sector having suffered weeks of punishment. However, profit margins in the US are a concern on account of rising input costs – principally from higher wages as the labour market tightens. Though margins remain high for now, they have been declining since having peaked around a year ago.

Our **TECHNICAL** indicators present a mildly negative picture. With investor positioning in Japanese stocks now looking excessively bearish, the asset class seems set for a particularly strong recovery. A similar observation can be made for US high yield. But the technical picture is much less positive elsewhere. We have found that an unusually narrow band of stocks are now trading above their 200-day moving averages which, in itself, suggests equities could fall further.

¹ In our model, the equity risk premium is the difference between the sum of a stock index's dividend yield and the trend GDP growth rate for the relevant region and the 10-year government bond yield.

Japan and emerging markets look good value



In our regional allocation, we keep our preference for equities in Europe and Japan, where central banks are expected to deliver additional monetary stimulus to support their economies. We also retain our overweight on emerging market stocks.

Japan remains an attractive equity market. Even though corporate Japan's profitability has held up well compared to its peers, P/E ratios for Japanese stocks have not expanded at all since the launch of Prime Minister Shinzo Abe's Abenomics policy in late 2012. Japan now ranks as the cheapest equity market on our scorecard.

At the same time, Japanese policymakers can be expected to provide more monetary and fiscal stimulus to support economic recovery; they are sure to be spurred by an export-sapping 10 per cent rise in the Japanese yen versus the US dollar since December.

The BoJ's move to introduce negative interest rates last month in a bid to weaken the yen and support the country's competitiveness suggests policymakers are committed to turning the country's fortunes around. Additional monetary policy easing would send a strong signal to markets and cre-

ate the conditions for Japanese stocks to recover.

There are many other reasons to be positive on Japanese stocks. First, labour market conditions are improving, which suggests a return to deflation is unlikely. Second, Japan is home to a cash-rich corporate sector that's under pressure to allocate capital more efficiently. This should give rise to more merger and acquisition activity and an increase in returns to shareholders.

Elsewhere, we retain our overweight on emerging market stocks as further evidence emerges that economic growth is stabilising, in China mainly but also in Latin America, where the pace of deterioration has slowed. The Citigroup Economic Surprises Index shows that emerging markets are now performing better versus their developed counterparts than at any point in the last four years.

The Chinese government has shown signs that it is determined to stabilise the economy and its volatile financial markets. Recent accommodative monetary and fiscal policies have already yielded some positive results with credit growth picking up. This improving outlook should also help other lift emerging markets. The recent stabilisation in the price of oil and other commodities is an additional factor that could lead to bounce in emerging stocks. Historically, a 1 percentage point pick-

up in global industrial growth results in a 6 per cent rise in emerging market company earnings – for US companies, the profit gain is around 4.5 per cent.

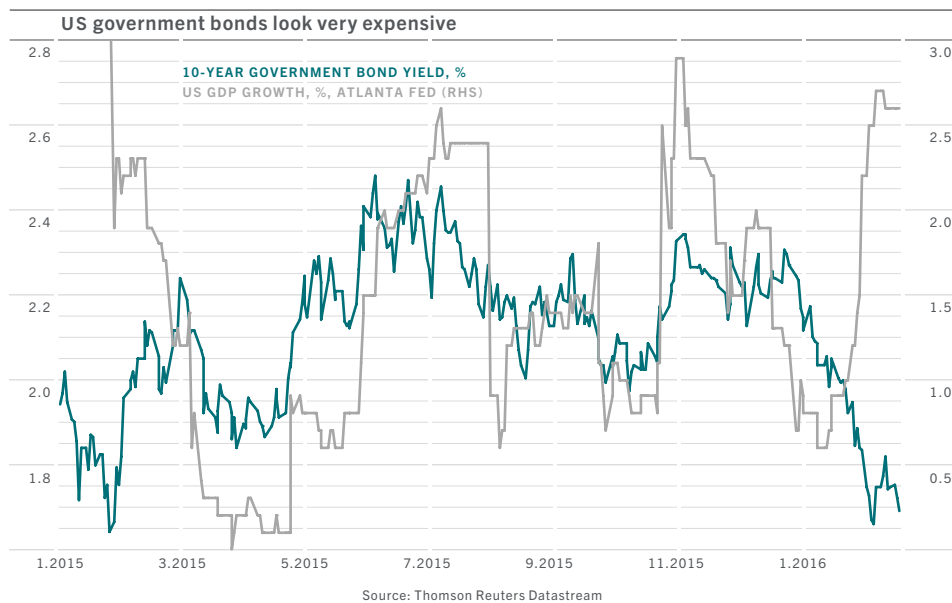
We also stick to our overweight stance on Europe. Economic growth across the region remains modest, and we expect output to expand at 1.6 per cent in 2016. Corporate profit margins should receive a boost from low energy costs and a recovery in exports. Monetary policy should also become more expansionary, and we expect the ECB to deliver more stimulus as early as its next meeting in March although we do not believe it will begin buying corporate bonds – the market is simply too small unless financial debt forms part of any plan.

That said, risks to Europe's recovery have grown in recent weeks. Italy's banking system has been rocked by a spike in non-performing loans on the balance sheets of some regional lenders while the UK is due to hold a referendum on whether to remain in the European Union.

Elsewhere, we upgrade UK equities to neutral as weakness in the pound sterling should boost the prospects of exporters.

Separately, we remain neutral on US stocks. Expectations for nominal GDP growth have fallen and profit margins have continued to decline. Indeed US profit margins have been in decline since peaking a year ago. One proxy for profit margins is the gap between producer price inflation and unit labour costs. Currently at 6 percentage points, the gap is the narrowest it has been since the 1950s. When it comes to sectors, we keep a moderate cyclical tilt. Materials stocks are the most exposed to a recovery in China, and stocks have already ticked up on the back of easing measures. We also like consumer discretionary and technology companies, which stand to benefit from a rise in consumer spending. Consumer staples meanwhile, look unattractive as they trade at their most expensive levels ever relative to other industry sectors.

A rich hunting ground for the optimists



Investors optimistic about the prospects for the world economy would be hard pressed to find a better way to express that view than via the fixed income markets. Yields on 10-year US Treasuries have tumbled by more than 70 basis points since the beginning of the year to below 1.7 per cent, levels last seen in February 2015. Meanwhile, the spread on US high-yield bonds has climbed to above 800 basis points – a breach that has occurred only three times in the past 20 years.

Both markets now imply the US is facing a severe risk of recession – according to our estimates, these markets are pricing in a 70-80 per cent probability of a slump. They also suggest the Fed will not raise interest rates any further over the next 12 months.

It's a scenario that is starkly at odds with the economic indicators we consider to be reliable predictors of a recession.

In the US, our gauges show that consumption remains healthy and that the property market is in good shape. And though the Fed recently made a small increase to interest rates, monetary policy is by no means tight. In other words, these two fixed income markets are in

particular underestimating the longevity of the US economy's growth spurt. It is worth noting that core inflation has already nudged up to 2.2 per cent, the highest level since June 2010.

With that in mind, we retain our underweight stance on government bonds and our overweight position in US high-yield debt.

Valuations for US high-yield bonds look particularly attractive.

At current prices, they imply that bond default rates will climb to levels of around 13 per cent. Such a deterioration in the creditworthiness of high-yield debt issuers is difficult to reconcile with the positive trends we see unfolding over the coming months.

For one thing, we expect the US economy to continue its expansion, fuelled by buoyant consumer spending. In addition, oil prices should also stabilise. That would be a significant plus for high-yield bond markets, which have suffered an especially heavy blow from the oil price rout due to the high number of speculative-grade debt issuers operating in the energy sector.

Also attractive are emerging market local currency bonds. Our proprietary indicators suggest economic activity has picked up considerably over the past three months across emerging markets, and we expect manufacturing-based countries within Asia to lead the recov-

ery over the coming months. Fiscal policy has also remained disciplined across the board, with the average cyclically-adjusted fiscal balance at about 2 per cent of GDP in aggregate, more or less in line with the historic average.

Public debt to GDP ratios remain low by world standards and the ability to pay is not in question. So with emerging market local currency bond yields hovering close to 7 per cent and currencies trading at levels that, by our calculations, are some three standard deviations below fair value against the US dollar, investors are well compensated for the risks inherent in the asset class.

In the currency markets, we hold an underweight position in sterling versus the US dollar as we expect the unit to decline further in the lead-up to the UK referendum on EU membership. We also retain our long euro, short US dollar position as we expect euro zone economic growth to gather strength. Our decision to retain an underweight stance on the US dollar is in keeping with the picture that emerges from our technical and sentiment indicators, which show investors are overly bullish on the US unit's prospects.

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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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