PICTET
1805
Asset Management

TACTICAL ALLOCATION
MONTHLY UPDATE

May 2016

BAROMETER

Rally has further to go

GLOBAL ASSET CLASSES

We stick to our overweight stance on equities and remain underweight bonds as monetary stimulus should underpin economic growth.

EQUITY REGIONS AND STYLES

Emerging market stocks should do well as China's economy continues to stabilise; we also like European stocks.

EQUITY SECTORS

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

FIXED INCOME

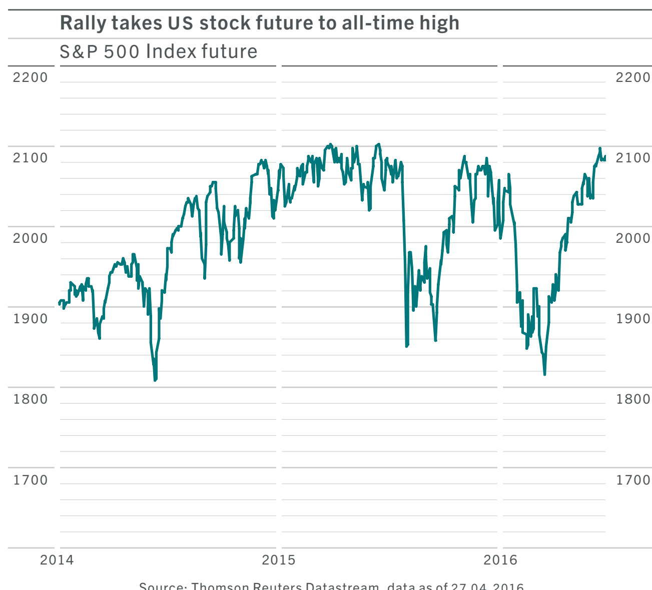
We remain overweight US high-yield and emerging market dollar bonds.

	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.

Equities extend gains; USD drops



Source: Thomson Reuters Datastream, data as of 27.04.2016

Equities extended last month's rally, outperforming bonds as concerns about economic growth in the US and China receded. A strong rebound in energy and resource prices and a drop in the US dollar aided emerging equities and bonds, especially in commodity – exporting economies.

Expectations that the US Federal Reserve will go slow in raising interest rates boosted US stocks, where the S&P 500 index climbed closer to last year's record high (see chart). Japanese shares eroded earlier gains, however, after the Bank of Japan disappointed investors by holding off expanding monetary stimulus and cutting inflation forecasts. Japanese stocks are down more than 3 per cent year-to-date in US dollar terms, among the worst-performing developed equity markets.

Emerging market stocks gained, supported by higher commodity prices and stabilisation in China's economy, lifting their year-to-date returns to just over 6 per cent in US dollar terms.

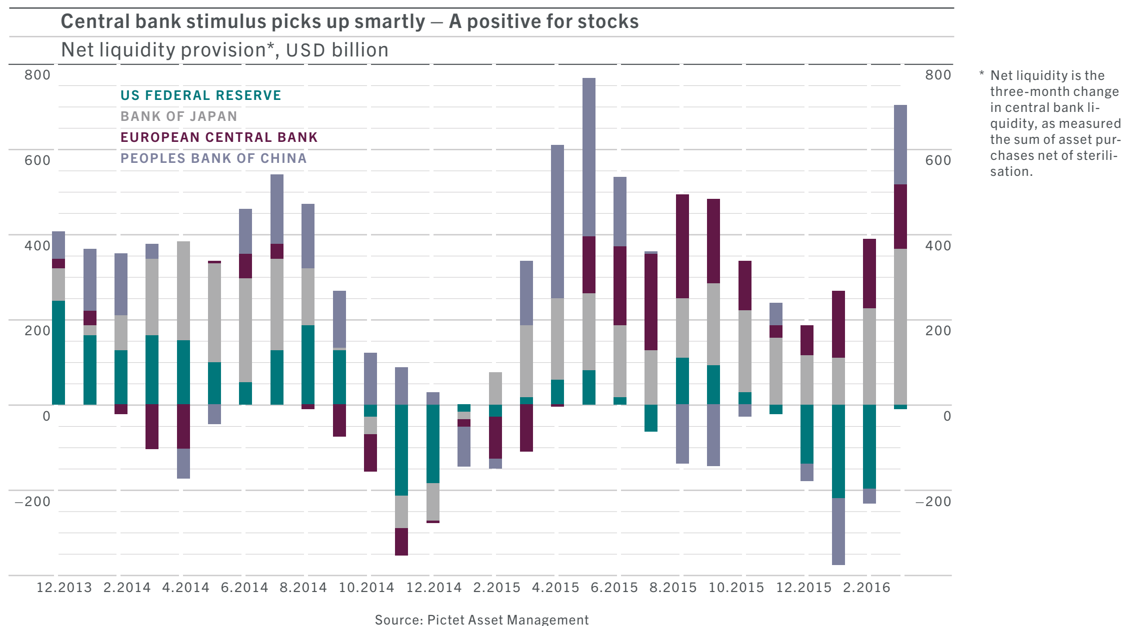
The Institute for International Finance (IIF) estimates emerging markets have now seen eight straight weeks of inflows, the longest streak since June 2014. It also predicts net outflows from emerging economies to ease to USD500 billion in 2016 from around USD750 billion last year.

Globally, energy and material stocks were the best performers by some distance, while IT shares fell the most on the back of disappointing earnings results from industry heavyweights. Apple, for example, reported its first decline in revenue since 2003. Financials also ended the month in negative territory as US banks' quarterly results pointed to continued weakness in the sector.

European high-yield debt rose more than 1 per cent after the European Central Bank announced plans in March to buy company debt. US high yield debt added a further 4 per cent in the month. Developed market government bonds were on average flat to lower, except in Japan where yields on long-dated government bonds hit historic lows. Emerging market bonds were among the best performing fixed income asset classes, with both US dollar and local currency debt registering gains of above 1.5 per cent.

In currency markets, the US dollar fell again in the month, widening this year's loss to nearly 7 per cent on a trade-weighted basis as investors scaled back expectations for the pace of US interest rate hikes. The Japanese yen jumped after disappointment from the BoJ which brought the Japanese currency's export-damaging gain against the dollar this year to over 11 per cent. The currency was on course to register its strongest weekly gain since the 2008 financial crisis. Commodity currencies, including the Brazilian real, Russian ruble and South African rand, extended last month's rally.

Receding global worries support equities



* Net liquidity is the three-month change in central bank liquidity, as measured the sum of asset purchases net of sterilisation.

Source: Pictet Asset Management

The global economy appears to be in better shape than earlier this year, when investors who panicked about the possibility of a sharp slowdown in the US and China sold off equities and other risk assets.

Still, even though riskier asset classes have recovered their poise in recent weeks, valuations continue to paint an overly pessimistic view of economic conditions.

The US Federal Reserve has suggested it is in no rush to raise interest rates and China's monetary authorities have taken steps to underpin growth, policies which have met with some success. Monetary policy in the euro zone and Japan, as well as some emerging economies, meanwhile, remains accommodative, keeping the overall level of liquidity high.

As a result, we are sticking to our pro-risk stance of being overweight equities and underweight bonds, where valuations are too high.

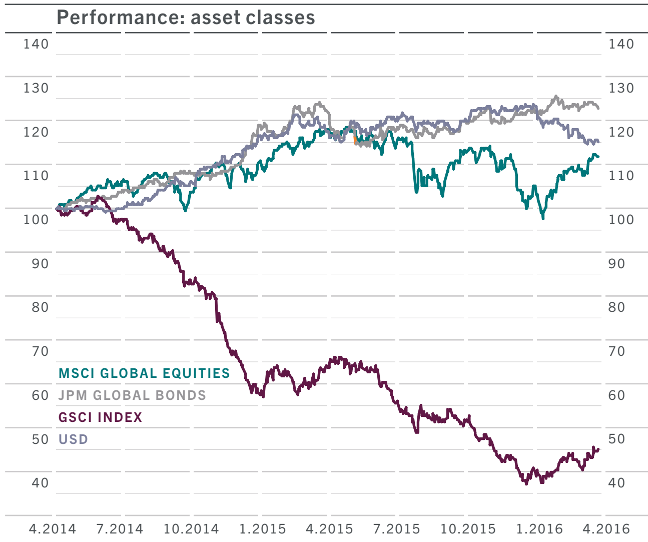
Our BUSINESS CYCLE indicators show that the US economy should grow at a moderate 2 per cent this year. Manufacturing activity continues to stabilise, albeit slowly, while strong labour market conditions should help retail sales and the housing market strengthen later this year. That said, we don't believe the US economy will be strong enough to justify an interest hike in June. Recent data showing the US economy grew just 0.5 per cent in the first quarter will hold the Fed in check.

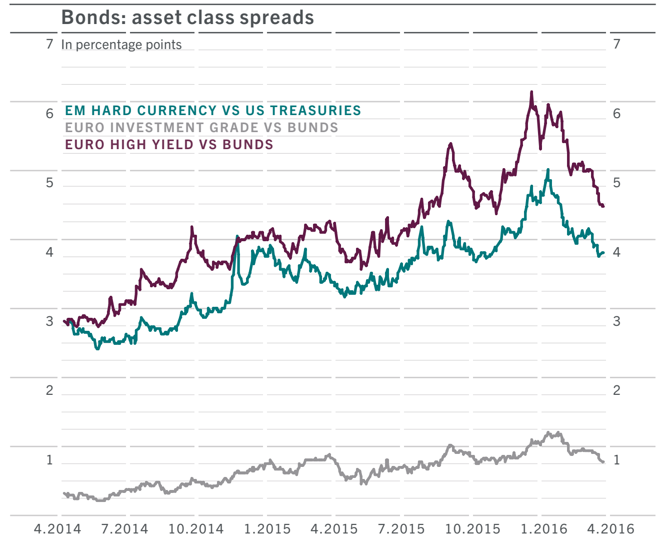
The euro zone continues to see a moderate recovery, helped by monetary stimulus from the European Central Bank. While sluggish global demand weighs on the region's large export sector, upbeat consumer sentiment and healthy private consumption are serving as engines of growth. Looking ahead, we would need more evidence that monetary policy is filtering through to the real economy, especially to countries in Southern Europe, for us to raise our forecasts for growth.

The outlook is less encouraging in Japan, where the risk of outright deflation has increased after a decline in manufacturing and export activity and a sharp drop in consumer prices and household spending. Despite the Bank of Japan's efforts to stimulate the economy, with negative interest rates and massive asset-buying, this has yet to translate into growth. The central bank cut its inflation forecasts in April and warned that it may not hit its 2 per cent inflation target until March 2018 at the earliest. The BoJ also disappointed investors by holding off expanding monetary stimulus this month, which raised worries that it is running out of options to support the economy. However, this raises the probability of expansionary fiscal policy. Prime Minister Shinzo Abe is likely to commit to extra public spending to fund re-construction in the earthquake-hit areas of southern Japan but expectations are rising that he may delay an unpopular sales tax hike, originally due in April 2017, and unveil further fiscal stimulus.

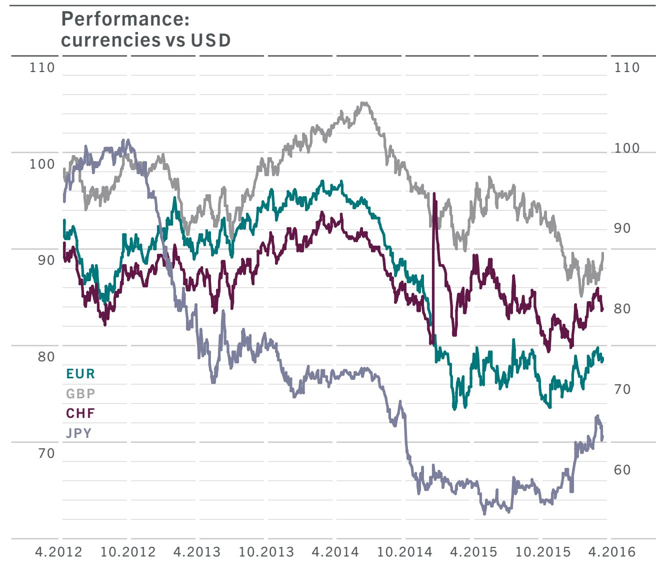
China is faring better, with its economy showing more signs of stabilisation. Industrial production rebounded last

Major asset classes





Equity sector rotation and currency performance

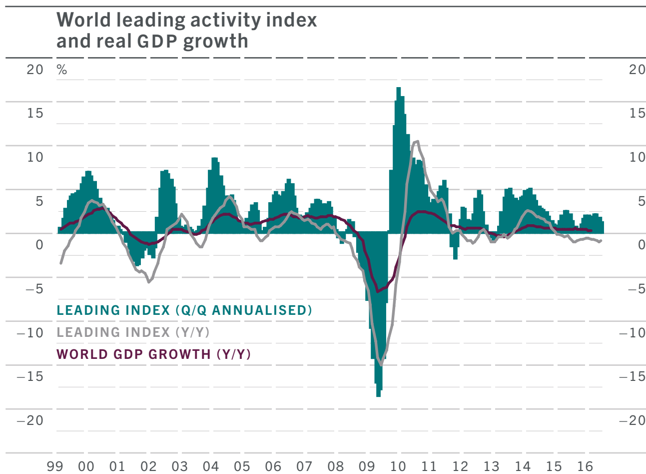


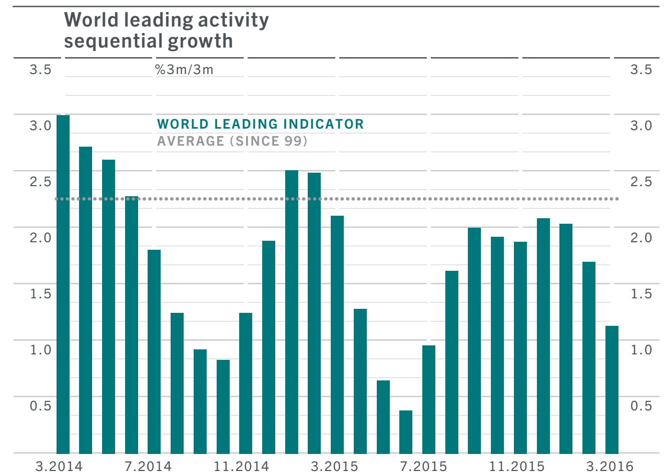
Source: Pictet Asset Management,
Thomson Reuters Datastream / JPM and BoA Merrill Lynch

Risk bias indicators

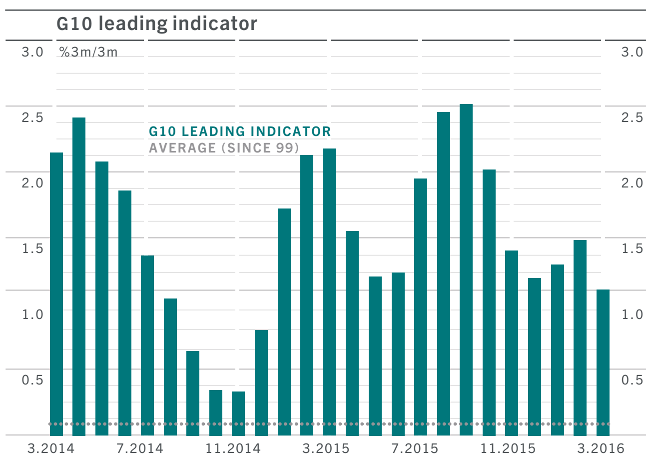
RISK BIAS INDICATORS	UNDERWEIGHT –		NEUTRAL o		OVERWEIGHT +	MONTHLY CHANGE <<<<	>>>>
				Business cycle			
				Liquidity			
				Valuation			
			Technicals				
				PAM Strategy			

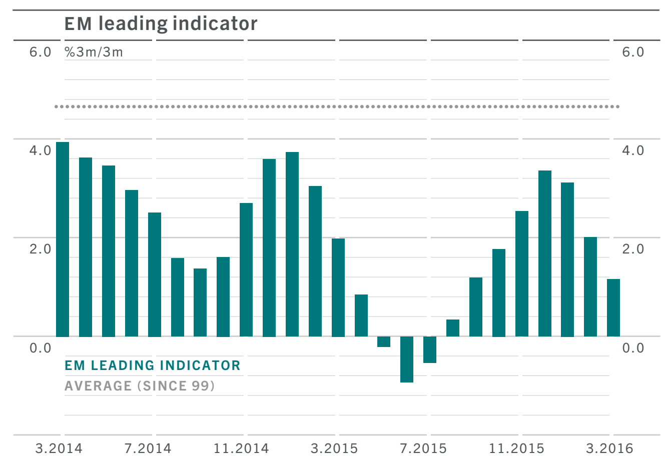
Business cycle: World economic growth remains moderate





Economic momentum eases slightly





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

Valuation:
Equity markets and sectors

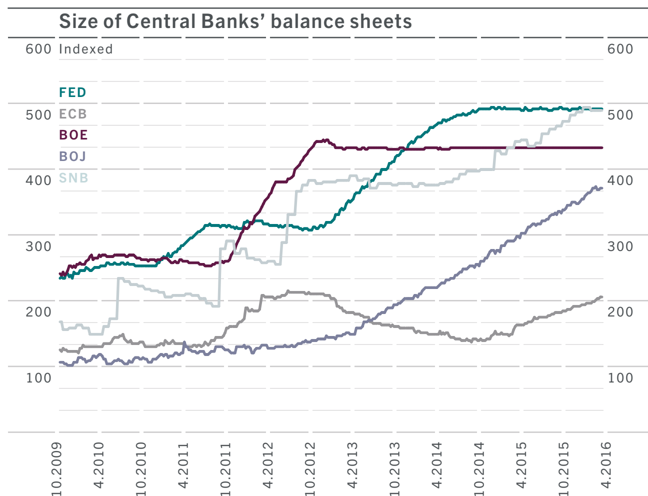
Countries and sectors

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%	17.8	16.9	2.7	1.8	2.2%
EUROPE	0%	14%	0%	5%	15.9	15.2	1.7	1.2	3.7%
EMU	2%	12%	1%	4%	14.7	14.1	1.4	1.0	3.6%
SWITZERLAND	2%	11%	1%	4%	17.6	17.0	2.4	2.2	3.4%
UK	-6%	19%	-4%	9%	17.1	16.1	1.8	1.3	4.2%
JAPAN	15%	7%	1%	3%	13.4	13.3	1.1	0.8	2.3%
EM	7%	14%	5%	9%	12.6	12.0	1.3	0.8	2.8%
NJA	4%	11%	5%	9%	12.7	12.2	1.3	0.7	2.8%
GLOBAL	**2%**	**13%**	**2%**	**6%**	**16.3**	**15.6**	**1.9**	**1.3**	**2.7%**

MSCI SECTORS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
	2016	2017	2016	2017	2016	2017	2016E	2016E	2016E
ENERGY	-44%	106%	-10%	19%	39.1	28.9	1.3	0.9	3.6%
MATERIALS	4%	20%	-5%	5%	19.3	17.9	1.7	1.0	2.4%
INDUSTRIALS	11%	11%	3%	4%	16.4	15.9	2.3	1.0	2.5%
CONSUMER DISCRETIONARY	11%	12%	5%	5%	15.9	15.4	2.5	1.1	2.1%
CONSUMER STAPLES	5%	10%	4%	5%	21.3	20.5	3.9	1.3	2.6%
HEALTH CARE	7%	11%	8%	6%	17.0	16.4	3.5	1.9	2.0%
FINANCIALS	1%	9%	4%	5%	12.2	11.8	1.1	1.6	3.5%
IT	4%	12%	3%	5%	16.6	15.8	3.0	2.2	1.7%
TELECOMS	7%	9%	4%	2%	15.5	15.1	2.1	1.3	4.1%
UTILITIES	-4%	3%	-1%	2%	14.8	14.6	1.4	1.0	3.9%

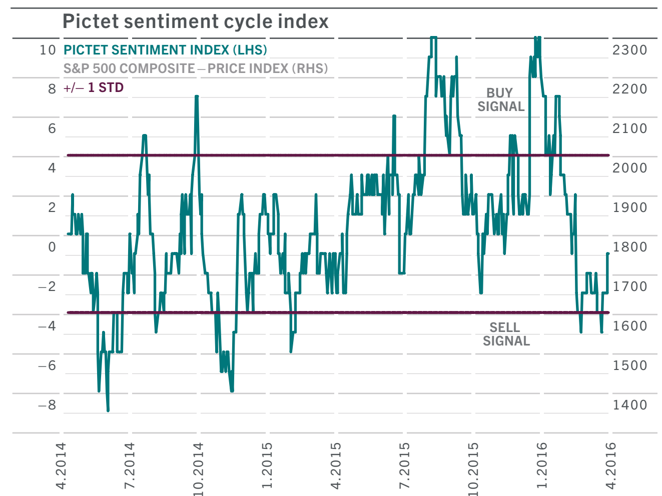
Liquidity: Fed begins to hike rates, but stimulus provided by other central banks

Size of Central Banks' balance sheets



Sentiment indicator shows risk of market correction

Pictet sentiment cycle index



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

month and the People's Bank of China's monetary stimulus is fuelling growth in the country's lending and money supply. The property sector, which accounts for around 15 per cent of the economy, is recovering further, led by Tier 1 cities, where house prices are rising more than 20 per cent year-on-year.

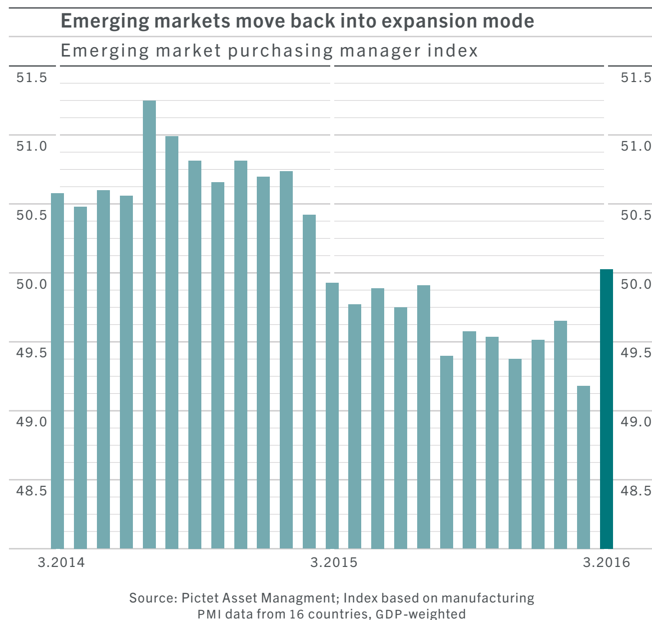
A more stable Chinese economy is supporting the rest of Asia, where strong consumer spending has lifted growth. Central banks in the region are particularly well-placed to either maintain monetary policy steady or cut interest rates further to support the economic recovery. But other emerging economies, especially Russia and Latin American commodity exporters, may start providing monetary stimulus as inflationary pressures there ease.

Our LIQUIDITY readings remain positive, backed by continued monetary stimulus from China, the euro zone and Japan. Receding expectations for a US interest rate cut over the summer are also supportive for the overall level of liquidity, which remains above a five-year average (see chart on page 2).

Our VALUATION signals show equities and other risky assets remain attractive relative to government bonds, but the markets have seen wide dispersion across regions and industries. US equities and European high-yield have moved into overvalued territory after a recent rally, while emerging Asia and Japan remain the cheapest stocks. With corporate profit margins at record highs, equities need solid revenue growth to sustain their momentum. However, earnings are still contracting worldwide, with US earnings falling 7 per cent on the year, the poorest showing since 2009. The earnings season has however, been better than expected, and could mark the low point of the recent profit decline.

Our TECHNICAL indicators are now in neutral territory, showing that riskier asset classes are no longer 'oversold' in the wake of the strong market rally. Nevertheless, global stock prices have risen above their 200-day moving average for the first time since October 2014. This has historically proved to be a strong 'buy' signal. Exceptionally strong investment inflows into emerging market debt and some global credit securities might prove unsustainable, while some of the other gauges we monitor suggest a correction may be on the cards for safe-haven gold and the Japanese yen.

Preference for emerging markets and telecoms



Source: Pictet Asset Managment; Index based on manufacturing PMI data from 16 countries, GDP-weighted

Emerging markets continue to benefit from the combined effect of a weaker dollar, a less hawkish Fed, recovering commodity prices and improving economic conditions in China. April saw the average manufacturing Purchasing Manager Index for emerging markets move back at the 50 threshold that separates expansion from contraction, a level last breached in February 2015. Economic data is the most encouraging in Asia, where we see evidence of an underlying improvement in industrial production and exports. These positive developments have lured investors back into emerging markets, with data from the IIF showing large portfolio inflows from institutional investors into range of asset classes. Tellingly, retail investors have so far favoured US dollar denominated emerging market bonds, which to us suggests they may soon increase their allocation to emerging market equities in the coming weeks.

The most powerful boost to emerging assets comes in the form of a steady improvement in economic data from China, which is in turn the result of Beijing' aggressive fiscal and monetary stance in the past year. Credit growth increased significantly in March, which has triggered a strong rebound in construction activity and led to some stabilisation in the manufacturing sector. However, this development has occurred at a pace which may not be sustainable in the long run – the stock of unproductive debt could prove to be a risk.

One other beneficiary of the stabilisation of China will be Japan, whose economy has slowed under the weight of cooling global demand, weak domestic consumption and the adverse impact of a strong Japanese yen. In our view, the country's economic troubles will provide the trigger for additional monetary stimulus by the central bank even though monetary authorities unexpectedly sat on their hands this month. We also expect Japan to provide more fiscal stimulus over the coming months.

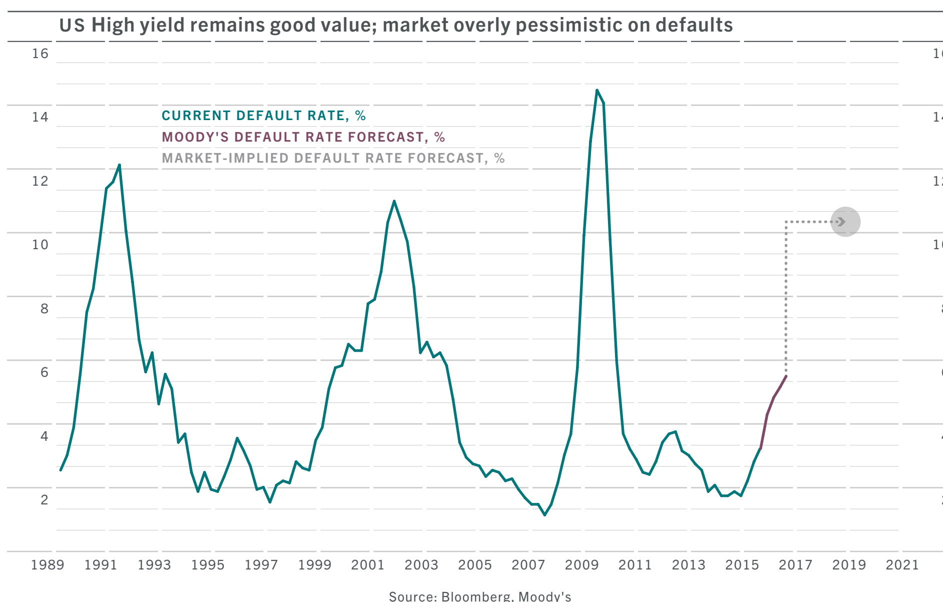
Sentiment towards the region seems overly bearish, particularly as the Japanese equity market currently offers some of the cheapest valuations in the developed world. The asset class's valuation also compares favourably to that of some emerging equity markets. There are already signs that non-Japanese investors have started buying stocks back.

European stocks also look appealing. Although they have gained ground since mid-February, they continue to lag the performance of their US counterparts, largely because foreign investors have scaled back their exposure to Europe in recent months. This seems unwarranted as Europe is the region that is likely to see an improvement in earnings growth as the positive impact of continued monetary stimulus filters through to the real economy and boosts consumer spending. Corporate earnings among European firms have fallen by some 19 per cent since the end of 2008 while those of their US peers have gained 51 per cent and we believe that trend is about to reverse, particularly as euro zone stocks enjoy a valuation advantage at 18 times earnings on a cyclically-adjusted basis, compared to 26 for the US.

US equities look unappealing as valuations are at record levels at a time when corporate earnings are falling. Although 80 per cent of US companies have delivered quarterly earnings that surpassed market expectations, earnings per share are down 7 per cent, a decline that has not been seen since 2009.

When it comes to sectors, we maintain a cyclical tilt in our portfolio with a preference for stocks that stand to benefit most from an increase in consumer spending rather than those exposed to business investment which remains sluggish. Strong job growth and low inflation will boost household budgets, benefiting consumer discretionary companies. Telecom stocks look good value and prospects for growth have improved with the first price rises in both Europe and the US in 20 years. The recent stabilisation in China and emerging markets and a recovery in commodity prices support materials. Consumer staples are the most expensive stocks, trading at a price to book of about four, which is double the market average.

High yield retains its appeal



Source: Bloomberg, Moody's

Valuation trumps all other considerations when it comes to deciding the make-up of our fixed income allocation. So it should come as no surprise that we remain underweight developed market government debt. Currently, some 35 per cent of sovereign bonds in the JP Morgan government bond index are trading at negative yields. That looks difficult to reconcile with the high probability of a rise in US interest rates later this year and increasing public and private debt levels in parts of Europe. That said, as insurance against a possible slowdown in US economic growth over the near term, we remain overweight ultra-long maturity US Treasuries, as yields on such securities appear reasonable.

Investment grade European bonds are not attractive, either, as we believe the effects of the ECB's extended bond purchase programme – under which it will now buy corporate debt – are already largely reflected in the market.

The near term prospects for US high yield bonds, by contrast, are bright. Even though the asset class's recent bounce has pushed the yield spread on these securities from its 2016 peak of 887 basis points to 625 basis points, this risk premium is still too high, in our view.

As the chart shows, the market is factoring in a prospective default rate of just over 10 per cent over the next 12 months – some distance from the current default rate of about 3 per cent and Moody's forecast of just over 6 per cent. Although certain segments of the high yield bond market are experiencing difficult business conditions – heavily indebted bond issuers from the energy industry in particular – the asset class should fare well even if the economy expands at a modest pace. Over the long run, we expect default rates to climb steadily to about 5 per cent, with defaults concentrated in the energy sector.

A steady improvement in economic conditions in China, a decline in the US dollar and a bounce in commodity prices have combined to increase the allure of dollar denominated emerging market sovereign debt. We therefore retain our overweight stance on the asset class. Sovereign dollar denominated emerging market bonds - which are less volatile than their local currency counterparts - enable us to capitalise on improved economic conditions in the developing world while remaining insulated from potentially turbulent conditions in the currency markets.

When it comes to currencies, we do not see many tactical opportunities in the near term. Last month we shifted to neutral on sterling from underweight and retain that stance. While, over the longer term, we expect the euro to appreciate against the US dollar, we are reluctant to overweight the currency in the lead-up to the UK's referendum on EU membership.

Disclaimer

This material is for distribution to professional investors only. However it is not intended for distribution to any person or entity who is a citizen or resident of any locality, state, country or other jurisdiction where such distribution, publication, or use would be contrary to law or regulation.

Information used in the preparation of this document is based upon sources believed to be reliable, but no representation or warranty is given as to the accuracy or completeness of those sources. Any opinion, estimate or forecast may be changed at any time without prior warning. Investors should read the prospectus or offering memorandum before investing in any Pictet managed funds. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Past performance is ot a guide to future perfomance. The value of investments and the income from them can fall as well as rise and is not guaranteed. You may not get back the amount originally invested.

This document has been issued in Switzerland by Pictet Asset Management SA and in the rest of the world by Pictet Asset Management Limited, which is authorised and regulated by the Financial Conduct Authority, and may not be reproduced or distributed, either in part or in full, without their prior authorisation.

For UK investors, the Pictet and Pictet Total Return umbrellas are domiciled in Luxembourg and are recognised collective investment schemes under section 264 of the Financial Services and Markets Act 2000. Swiss Pictet funds are only registered for distribution in Switzerland under the Swiss Fund Act, they are categorised in the United Kingdom as unregulated collective investment schemes. The Pictet group manages hedge funds, funds of hedge funds and funds of private equity funds which are not registered for public distribution within the European Union and are categorised in the United Kingdom as unregulated collective investment schemes.

For Australian investors, Pictet Asset Management Limited (ARBN 121 228 957) is exempt from the requirement to hold an Australian financial services license, under the Corporations Act 2001.

For US investors, Shares sold in the United States or to US Persons will only be sold in private placements to accredited investors pursuant to exemptions from SEC registration under the Section 4(2) and Regulation D private placement exemptions under the 1933 Act and qualified clients as defined under the 1940 Act. The Shares of the Pictet funds have not been registered under the 1933 Act and may not, except in transactions which do not violate United States securities laws, be directly or indirectly offered or sold in the United States or to any US Person. The Management Fund Companies of the Pictet Group will not be registered under the 1940 Act.

Issued May 2016
© 2016 Pictet

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)

EDITORIAL TEAM

Olivier Ginguené
Co-chairman
Pictet Asset Management
Strategy Unit

Percival Stanion
Co-Chairman
Pictet Asset Management
Strategy Unit

Luca Paolini
Chief strategist
Pictet Asset Management
Strategy Unit

Pictet Asset Management Limited
Moor House, 120 London Wall
London EC2Y 5ET

group.pictet
pictetfunds.com