PICTET
Asset Management

TACTICAL ALLOCATION MONTHLY UPDATE
FOR PROFESSIONAL INVESTORS ONLY

July 2016 BAROMETER

Silver linings to Brexit clouds

GLOBAL ASSET CLASSES

We increase our exposure to global stocks to overweight as we expect policymakers to act decisively in the wake of the Brexit referendum.

EQUITY REGIONS AND STYLES

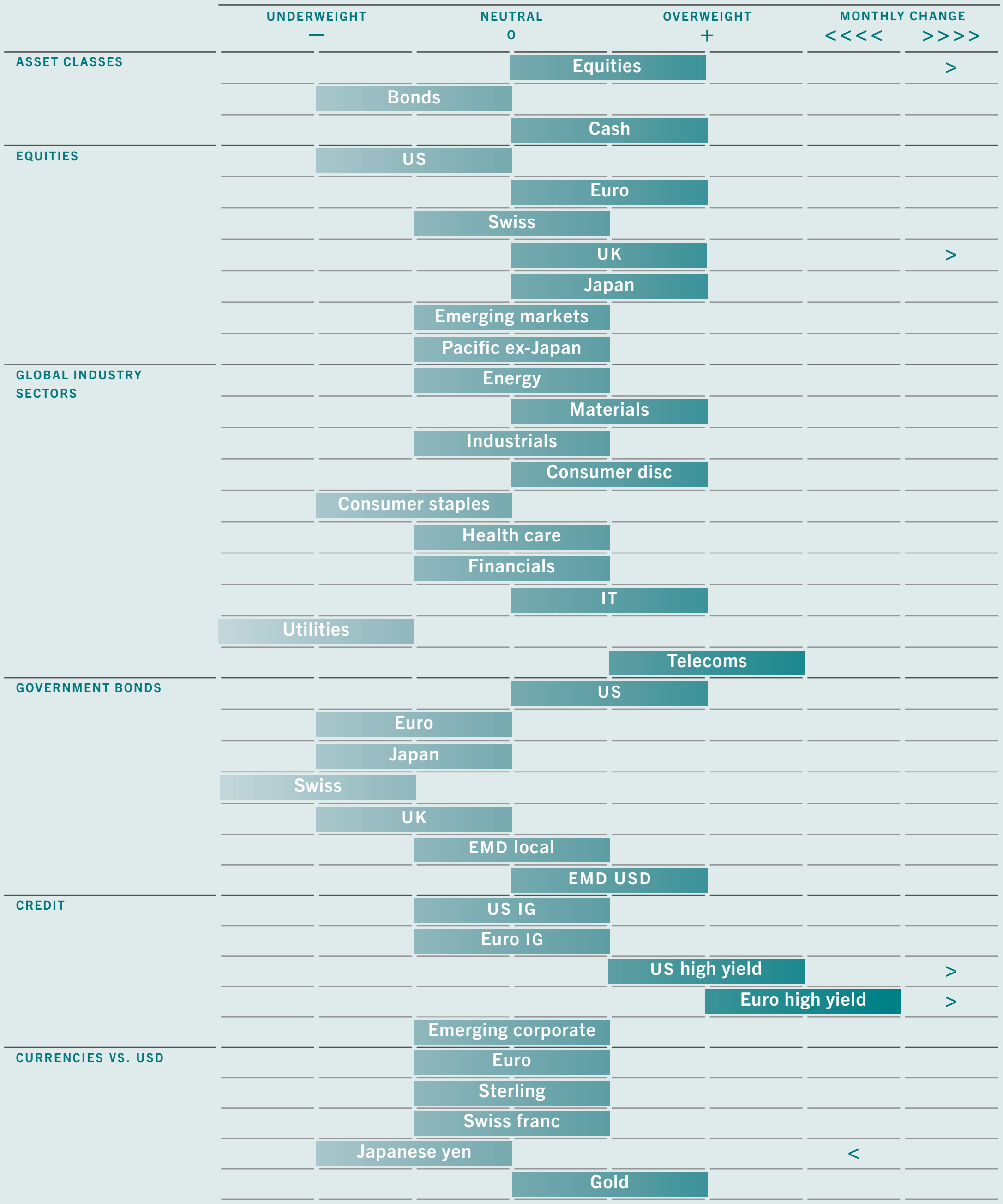
We remain overweight Europe and Japan on valuation grounds and upgrade UK stocks to overweight.

EQUITY SECTORS

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

FIXED INCOME

We upgrade US and EUR high yield bonds and go underweight the Japanese yen.



THE PICTET ASSET MANAGEMENT STRATEGY UNIT (PSU)

is the investment group responsible for providing asset allocation guidance across stocks, bonds, cash and commodities.

Brexit unleashes turmoil in global markets

Brexit takes sterling to 31-year low vs US dollar

GBP/USD exchange rate

Source: Thomson Reuters Datastream

Global equities swung wildly, bonds and gold rallied while sterling hit a 31-year low against the US dollar after the UK unexpectedly voted to leave the European Union in a referendum.

Stocks initially plunged in response to the ballot, but staged a recovery in the final week of the month amid expectations that policymakers would move to contain the fallout from the UK's looming departure from the EU.

Large-cap UK stocks represented in the MSCI UK index ended up 5 per cent in local currency terms while global stocks were down just 1 per cent. European shares underperformed their US and UK counterparts, however, amid worries that the UK vote would dramatically alter Europe's political landscape. Japanese equities fell as safe-haven flows sent the Japanese yen up by more than 7 per cent against the US dollar, hurting the stocks of exporters. Emerging market stocks gained, meanwhile, as Brexit all but eliminated the prospect of a rate rise from the US Federal Reserve this year.

Financials were the worst performers, with some stocks losing as much as 30 per cent in a day as the UK vote raised concerns about the health of European banks, already struggling to generate profits in an environment of low or negative interest rates.

In fixed income, US, Japanese and European benchmark government bond yields hit fresh record lows as investors expected central banks to keep monetary policy loose in the wake of Brexit.

Having experienced its steepest daily decline in the post-1973 floating exchange rate era on June 27, sterling came under renewed pressure towards the very end of the month as Bank of England Governor Mark Carney suggested the central bank may cut interest rates over the summer.

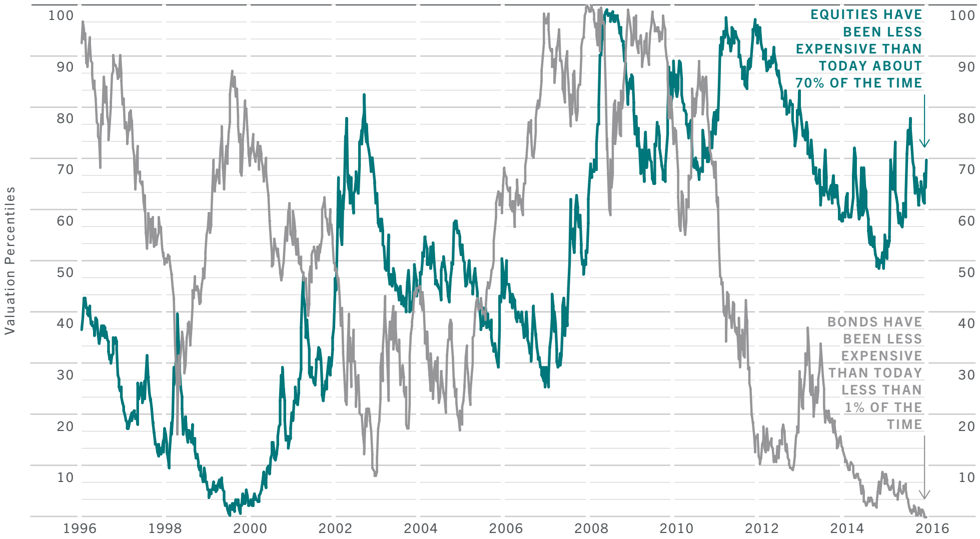
Emerging currencies and bonds rose across the board, lifted by expectations the Fed will turn increasingly dovish. Emerging currencies were up 2 per cent against the dollar on the month. Latin American currencies were the biggest outperformers, rising nearly 10 per cent, while emerging local and hard currency debt rose between 3 and 6 per cent.

The Chinese renminbi fell 1 per cent against the dollar during the month in a sign that the People's Bank of China is allowing market forces to play a bigger role in determining the exchange rate. Buying from risk-averse investors pushed gold by 9 per cent.

Upgrading equities, reassessing Brexit

Equities remain good value vs fixed income

Stocks and government bonds: valuation relative to 20-year history, expressed as a percentile



When valuation gap was this wide in the past (2003, 2012), equity outperfomred bonds by double digits in the following 6m in both cases.

Details on valuation metrics below: Equities Valuation, MSCI ACWI: average of price to book, 12m PE, PE on trend EPS, price to sales and equity risk premium. 20 years percentiles. Bonds, JPM GBI: Yields minus trend nominal GDP growth (Hodrick-Prescott filter). 20 years percentiles

Source: Pictet Asset Management

The UK's vote to leave the EU has sent shockwaves through financial markets. The political upheaval unleashed by the unexpected referendum result and the ensuing rise in market volatility will surely weigh on the global economy. But there are silver linings to the Brexit clouds – alert to the need to contain the fallout from UK's landmark decision, policymakers are sure to act, relaxing fiscal austerity and maintaining a loose monetary policy.

For instance, we now expect the Fed to leave interest rates on hold at least until next year, offering substantial support to riskier asset classes. Moreover, Brexit may encourage governments in both Europe and elsewhere to push through economic stimulus to measures to insure against shocks. This, coupled with the fact that valuations for stocks are now at more attractive levels than they were a few weeks ago, has led us to upgrade equities to an overweight from neutral and to stay underweight bonds.

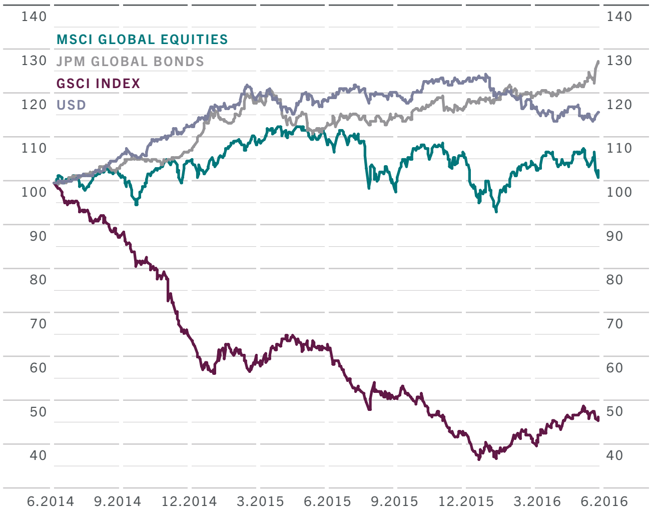
At the same time, however, and as an insurance policy against any further bouts of volatility, we keep our overweight stance in gold.

According to our BUSINESS CYCLE indicators, growth is slowing somewhat in the US because of weaker investment and manufacturing activity, and sluggish exports, which are suffering thanks to the strong US dollar. Labour market conditions are weakening too, with the economy adding only 38,000 jobs in May, the fewest since September 2010. However, the decline in non-farm payrolls growth does not point to a sharp slowdown, and recent consumption data shows more evidence of resilience. Following the Brexit vote, it now seems unlikely that the Fed will raise the cost of borrowing this year; the market is now implying that the next rate rise will not materialise until 2018. Easier-than-expected US monetary policy should help underpin growth, in our view.

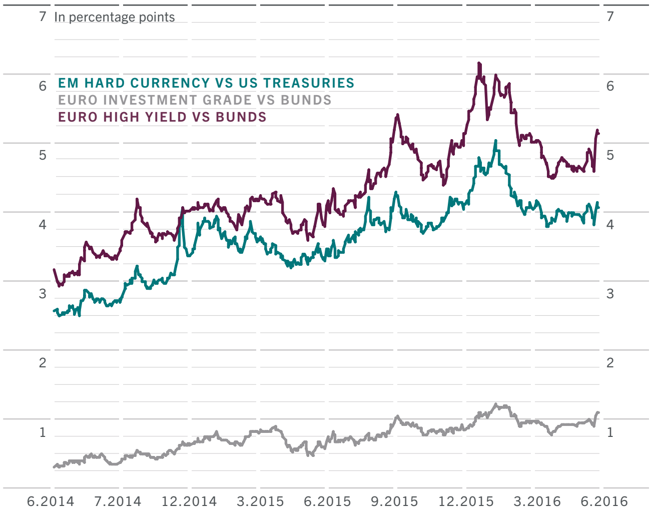
The euro zone economy, meanwhile, has been growing moderately, supported by European Central Bank stimulus measures, low oil prices and better labour market conditions. Also, the euro zone manufacturing PMI has risen to its highest level in six months. However, the fallout from Brexit is sure to weigh on business and consumer confidence as the year progresses. Political developments will have the biggest influence on business sentiment in the near term. We are closely watching Italy's plans to recapitalise its banks, which are saddled with EUR360 billion of bad loans –

Major asset classes

Performance: asset classes

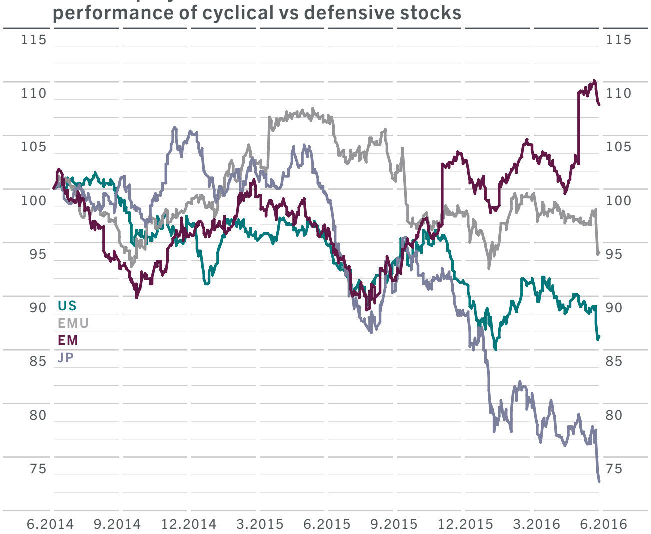


Bonds: asset class spreads

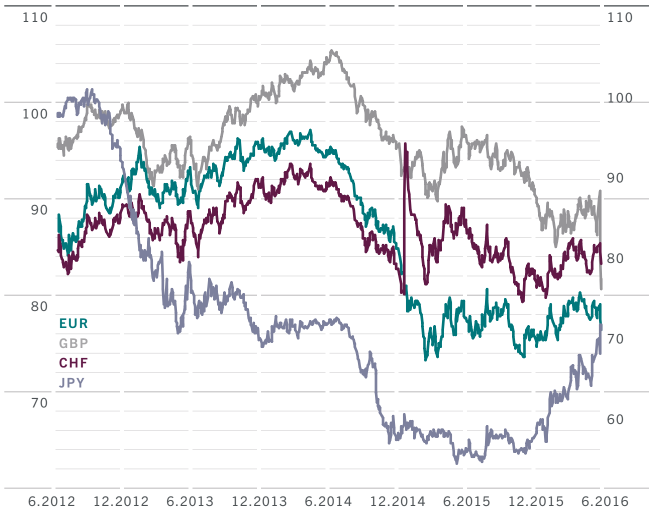


Equity sector rotation and currency performance

Global equity sector rotation: performance of cyclical vs defensive stocks



Performance: currencies vs USD



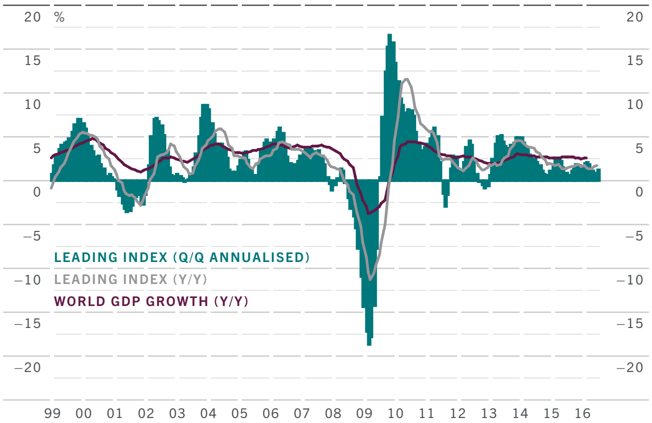
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

Risk bias indicators

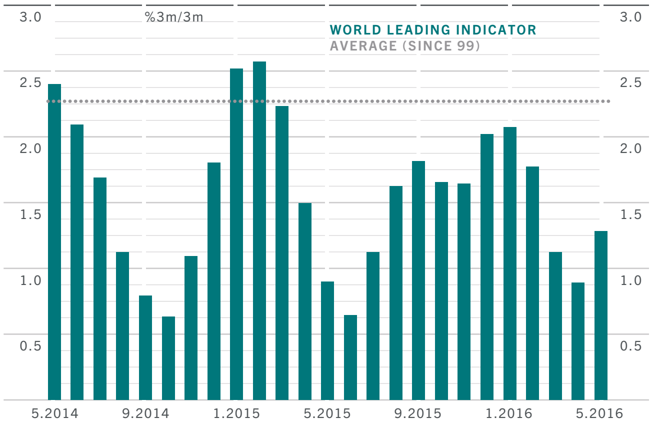
RISK BIAS INDICATORS	UNDERWEIGHT —	NEUTRAL o	OVERWEIGHT +	MONTHLY CHANGE <<<< >>>>
Business cycle		Business cycle		
Liquidity		Liquidity		
Valuation		Valuation	Valuation	
Technicals		Technicals		
PAM Strategy		PAM Strategy		

Business cycle: World economic growth remains moderate

World leading activity index and real GDP growth

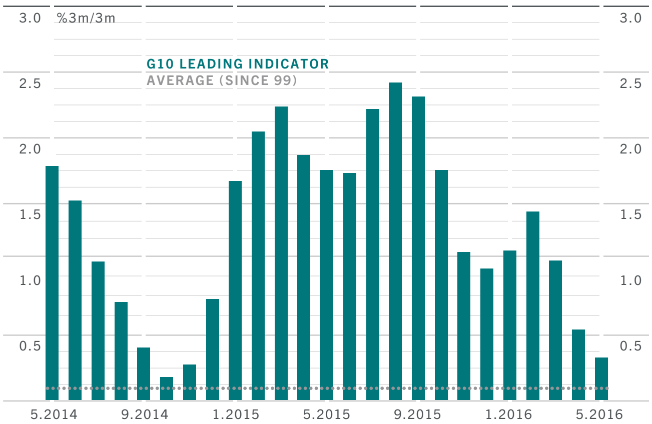


World leading activity sequential growth

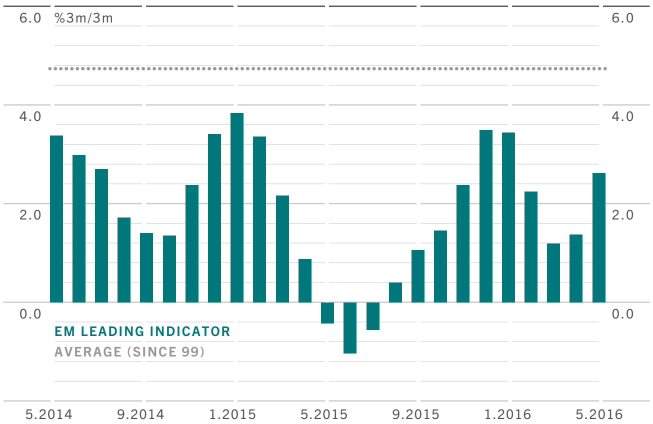


G10 economic momentum eases slightly

G10 leading indicator



EM leading indicator



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

Valuation:
Equity markets and sectors

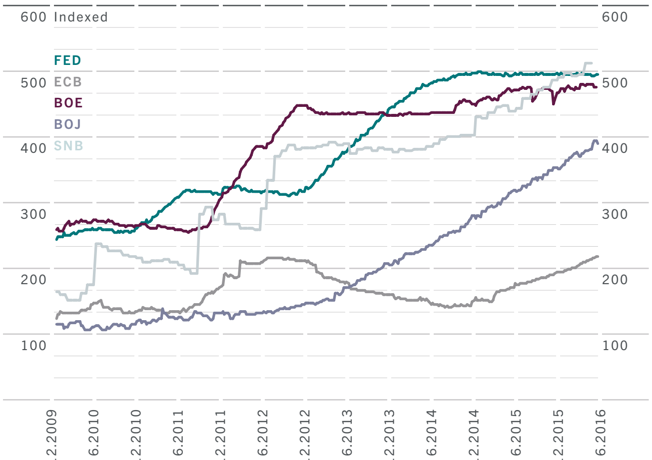
Countries and sectors

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%

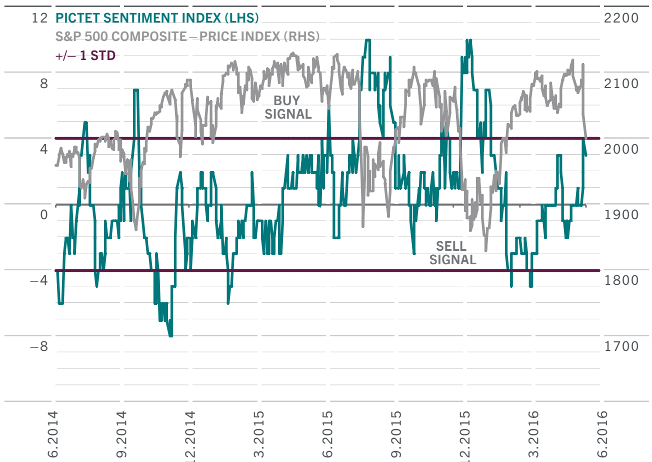
Liquidity: Fed likely to stay on hold; stimulus provided by other central banks

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

a third of the euro zone's total. If Italian Prime Minister Matteo Renzi manages to convince EU partners to be more flexible on state aid for banks, this could give a strong positive signal. A gradual relaxation of fiscal deficit targest would also suggest that European governments are ready to do more do boost growth, building on the expansive monetary policies set in motion by the ECB.

Japan's growth momentum remains weak. A strong Japanese yen is weighing on exports and the manufacturing sector. While improving labour market conditions should support consumption, headline inflation is edging further into negative territory. Prime Minister Shinzo Abe postponed a proposed VAT hike until October 2019, while authorities are also likely to support the economy with fiscal and monetary easing. The government is expected to announce fiscal spending of up to JPY10 trillion and the Bank of Japan may purchase more exchange-traded funds to extend the scope of its quantitative easing.

In China, economic activity is stabilising, underpinned by Beijing's recent fiscal and monetary stimulus measures. The housing market is accelerating further, especially in Tier 1 cities. Although the renminbi has depreciated in recent weeks and is near a five-year low against the dollar, capital outflows from China have so far remained muted. This is something we will be monitoring closely in the coming weeks.

Elsewhere in emerging economies, China's renewed stability and expectations that the Fed will keep its monetary policy on hold should underpin growth in the near term. Some emerging economies are also increasing spending to support their economies, with South Korea planning a fiscal stimulus package of more than KRW20 trillion (USD17 billion). In another positive development, India is looking to pass a key tax reform bill sooner than expected.

Our LIQUIDITY conditions stand at a neutral level for a second consecutive month. Expectations that the Fed will remain on hold until at least the end of this year, and the likely expansion of the BOJ's ETF buying programme, should lead to improved liquidity conditions in the coming months.

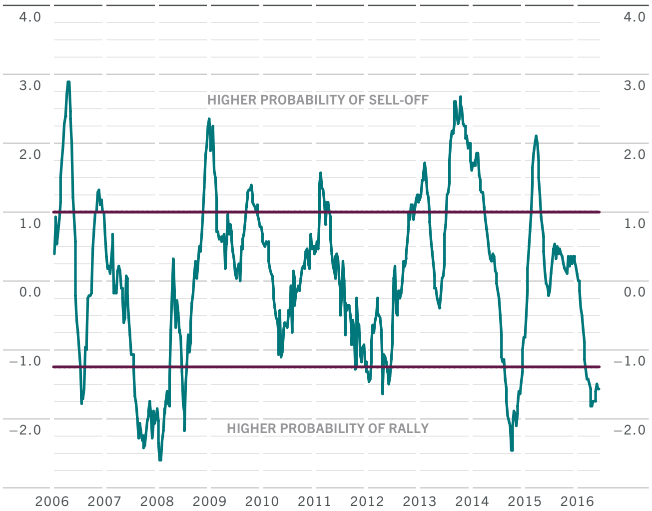
Our VALUATION signals show equities continue to be attractive relative to bonds. Our model indicates that Japanese shares are now approaching their cheapest levels on record, both in absolute terms and relative to other asset classes. European shares have also become much better value.

Our technical readings suggest riskier asset classes are now in oversold territory, raising the prospect of a bounce. Our indicators are also favourable for government bonds and credit, asset classes tend to do better than their riskier counterparts in the summer months. Seasonal factors also favour gold, even though the latest rally limits the scope for further gains in the precious metal.

Prospects encouraging for Europe, Japan and UK stocks

Heavy outflows from European stocks suggest rebound in store

Investment flows into European ETFs, as % NAV, 12-week moving average



Source: Pictet Asset Management

We retain our preference for European and Japanese stocks as the turbulence triggered by the UK referendum has taken their valuations to levels that are at odds with fundamentals. Both markets stand to benefit from monetary and fiscal stimulus from the Japanese and European authorities. We have also upgraded UK stocks to overweight.

The euro zone continues to see modest growth, led by household spending in the first quarter, and we expect the economic recovery to continue at a steady pace. Meanwhile, the ECB has said it stands ready to provide additional liquidity to mitigate the impact of the vote and shore up the currency bloc. Equity risk premia in Europe are in line with their levels during the financial crisis of 2008.* What is more, analyst consensus corporate earnings forecasts for European firms have turned higher in recent weeks even though Brexit might eventually slow that advance. The technical picture is also positive for European stocks. As the chart shows, European stocks have suffered heavy outflows over the past few weeks, suggesting investor positioning is now excessively bearish, increasing the scope for a rebound.

* In our model, the equity risk premia is calculated using European stocks' 12-month forward P/E ratio, trend nominal GDP growth, the 10-year Bund yield and assumes a dividend payout ratio of 45 per cent.

In the UK, fears over what Brexit might hold in store for the UK economy has seen a number of domestically-exposed companies such as banks, homebuilders and real estate punished by investors. On reflection, however, we believe the overall market is not as vulnerable to political turmoil as it would appear.

The UK equity market is very diverse, composed of a mix of companies active in cyclical sectors such as energy and materials – which benefit from the recent recovery in commodity prices – and more defensive, multi-nationals that should reap significant gains from the weakening of sterling. In addition, we believe the government may look to enact some business-friendly reforms to reassure investors post-Brexit, including a potential cut in the corporate tax rate that would be an additional support for UK companies.

In Japan, the recent correction has pushed the equity market to levels that make it one of the cheapest asset classes on our global scorecard. This in part reflects the fact that Japanese Prime Minister Shinzo Abe's economic revival programme is struggling to lift growth; declining valuations are also a response to a stronger yen, which could prove to be a drag on Japanese exporters' profits.
However, the strength of the currency may force a policy response, one that will probably take the form of monetary and fiscal stimulus. According to our models, which takes into account bond yields and the value of the yen, Japanese equities exhibit a 10 per cent upside.

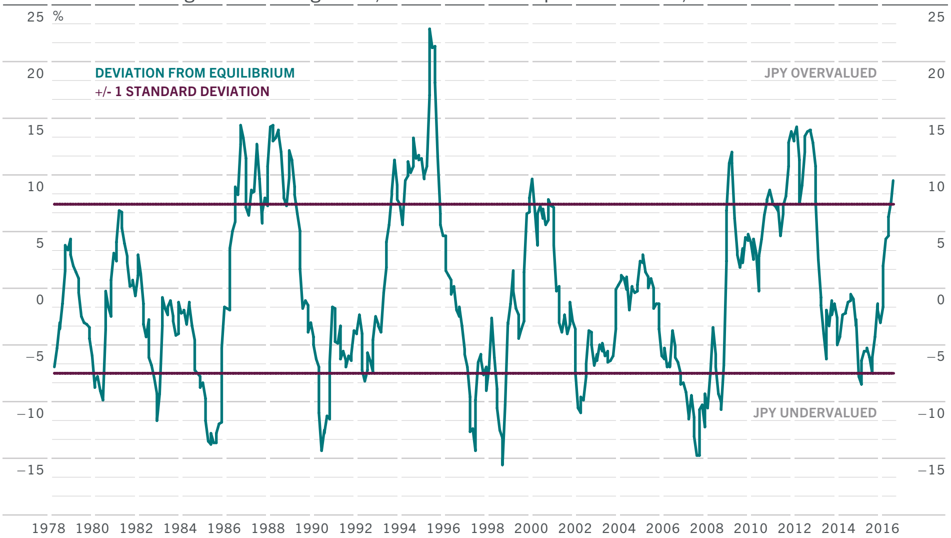
When it comes to sectors, we continue to favour those most exposed to a recovery in economic growth. Consumer discretionary companies should benefit from stronger spending in the US in particular. Telecoms look the most attractive of all sectors based on valuations, and within the sector, Japanese stocks look especially cheap.

Financials stocks also look inexpensive but the Fed's decision to hold off from raising rates – which will keep a lid on US banks' profit margins – and Italy's banking problems, prevent us from raising our exposure. That said, a comprehensive package to rescue ailing Italian banks would lead us to revisit the sector.

Overweight high yield, cutting Japanese yen to underweight

Japenese yen overvalued

JPY trade-weighted exchange rate, deviation from equilibrium level, %



Source: Pictet Asset Management; equilibrium level calculated using a formula that incorporates Japan's consumer price inflation, productivity and holdings of net holdings of foreign assets

How global central banks choose to react to Brexit will have a major bearing on world bond markets and currencies over the coming months, with investors particularly focused on the Fed.

Until recently the markets had priced in two US rate increases for the second half of 2016. Following the referendum, investors started to discount no move until well into 2017 or even 2018. At the same time, the Fed's forward guidance is likely to become more dovish – its dot plot forecasts over the coming policy meetings are likely to show voting members trimming their long run expectations for the Fed funds rate.

Meanwhile, the BoJ, ECB and the BoE are all likely to maintain their accommodative stances. Although the impact of any new measures in isolation would probably be modest, a coordinated policy response has the potential to trigger a strong rally in higher-yielding bonds.

For now, we expect the Fed's dovish tilt to drive a further flattening of the yield curve as it feeds demand for long dated US government bonds. So we remain overweight US Treasuries and are extending the duration of our portfolio.

We are less enthusiastic about other developed market sovereign debt. While UK gilts are also likely to draw support from the rising prospect of further BoE easing and seasonal and technical factors also favour developed government debt over riskier assets, many sovereign securities are very expensive. With most of these bonds offering negligible or negative yields and therefore limited scope for gains, we continue to keep an underweight stance on government debt, including Swiss bonds.

A more dovish monetary policy, however, is supportive of credit, particularly corporate high yield. We are lifting our exposure to US high yield bonds and are also shifting to an overweight on European high yield debt from neutral. On the other hand, European investment grade credit looks fully valued – investors are already long the market in response to the ECB's corporate bond purchase programme.

The shift in the Fed's thinking is likely to be positive for emerging market debt. This reinforces the attraction of a 400 basis point yield premium offered by emerging dollar debt over US Treasuries.

While we remain overweight emerging market dollar bonds, for now we stick to our neutral stance on emerging market local currency debt, as developing world currencies could prove volatile in a shifting political landscape.

Elsewhere, we have reduced our Japanese yen allocation to underweight from neutral. Our valuation model shows the Japanese currency is trading around one standard deviation above fair value, which suggests the currency could reverse course.
We remain neutral on other currencies. While the dollar has appreciated strongly during recent months and it might come under pressure from an easier Fed policy, it could just as easily see inflows from investors seeking defensive assets.

The rising prospect of political upheaval post-Brexit underpins our decision to continue to overweight gold, despite its run higher this year.

Disclaimer

Issued July 2016

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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