PICTET
1805
Asset Management

MONTHLY CHANGE
Maximum change ◀◀◀◀ ▷▷▷▷

GLOBAL ASSET CLASSES

Though markets have rebounded since the summer turbulence, we have held off adding risk for now, looking for signs of a more solid earnings outlook.

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE
			Equities			
			Bonds			
			Cash			
				Gold		
			Oil			
			USD			

EQUITY REGIONS AND STYLES

We keep our preference for Europe and Japan where valuations remain compelling and the prospects for corporate earnings are the brightest.

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE
				Japan		
	US					
					Europe	
		Pacific				
			Emerging			
				Mid & Small Cap		
			Value			

EQUITY SECTORS

We maintain a moderate tilt towards cyclicals as defensive sectors such as consumer staples are looking expensive. Financials should benefit from a US rate rise.

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE
			Energy			
			Materials			
			Industrials			
			Consumer Disc			
		Consumer Staples				
		Healthcare				
				Financials		
					IT	
			Telecoms			
		Utilities				

FIXED INCOME

We downgrade EUR government bonds on valuation grounds but raise exposure to emerging market corporate debt.

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE
		EUR Government				◀
		EUR Investment Grade				
				EUR High Yield		
				EMD Hard (USD)		
		EMD Local				
				EM Corporate		▷

Treading carefully as markets rebound

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

November 2015

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 2 November 2015

Global market overview

Global stocks stage relief rally

World equity markets recorded their strongest monthly gains in four years in October as major central banks' stimulus plans helped assuage concerns about global growth and the potential impact of a US rate hike.

The rally took the US S&P500 and Eurofirst 300 Indices back into positive territory for 2015. Cyclical equity sectors saw double-digit percentage gains in US dollar terms, with energy and material stocks leading the market higher. Defensive sectors such as utility and health care stocks saw the smallest rise.

Developed market stocks were not the only beneficiaries of central bank largesse – emerging market equities and bonds and high-yield debt also ended the month sharply higher.

Even though the US Federal Reserve issued an unexpectedly hawkish statement at its 28 October meeting, the markets took their cues from dovish signals from policymakers elsewhere.

Days before the Fed announcement, the European Central Bank confirmed the US and euro zone are embarking on divergent monetary paths as its President Mario Draghi hinted at more stimulus to counter deflationary pressures. Meanwhile, the Swedish central bank expanded its QE programme by 50 per cent.

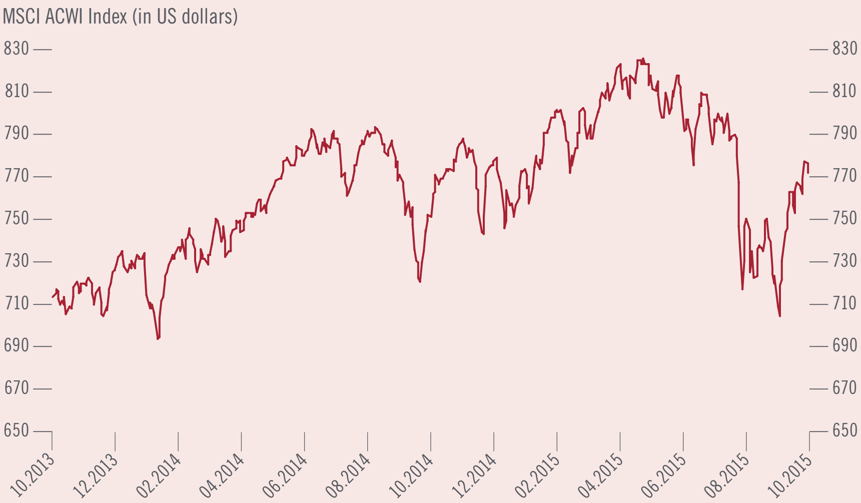
Elsewhere, the People's Bank of China cut interest rates for the sixth time in 12 months in a bid to bolster growth. It lowered the benchmark interest rate by 25 basis points to 4.35 per cent and trimmed the reserve ratio requirement for commercial banks by 50 basis points.

This potential injection of additional central bank stimulus from Europe and Asia eclipsed the Fed's warning about a possible rate rise in December. Fed policymakers voted to leave interest rates unchanged but kept the prospect of a rate rise on the table in December, as they played down the risks to the economy from global developments.

The growing divergence in monetary policy worldwide was reflected in the fixed income markets. In the euro zone, yields on Italian and Spanish two-year government bonds sank into negative territory for the first time while the yield on the two-year German Bund hit a record low of -0.32 per cent. In the US, meanwhile, government bond yields headed higher, with the yield on the 10-year Treasury rising to 2.1 per cent, a two-month high.

In currency markets, the US dollar rose against the euro but fell against many emerging market currencies.

GLOBAL STOCKS BOUNCE BACK IN OCTOBER



Source: Thomson Reuters Datastream

Asset allocation

Outlook improving but too early to add risk

After the late summer turmoil, October saw equity markets rebound, with global stocks witnessing their strongest monthly rally in four years. However, we have chosen to retain our neutral stance on equities as we look for more evidence of an improvement in both global growth and corporate earnings prospects. Though economic fundamentals are broadly encouraging, there are reasons for caution, not least the ongoing uncertainty over the direction of US monetary policy. The shift in the Fed's stance could pressure some riskier asset classes, particularly emerging markets, which have staged a moderate recovery in recent weeks. Still, we think the chances of a US rate hike being delivered in December are finely balanced. And even if the Fed does raise rates then, any additional tightening is likely to be very gradual.

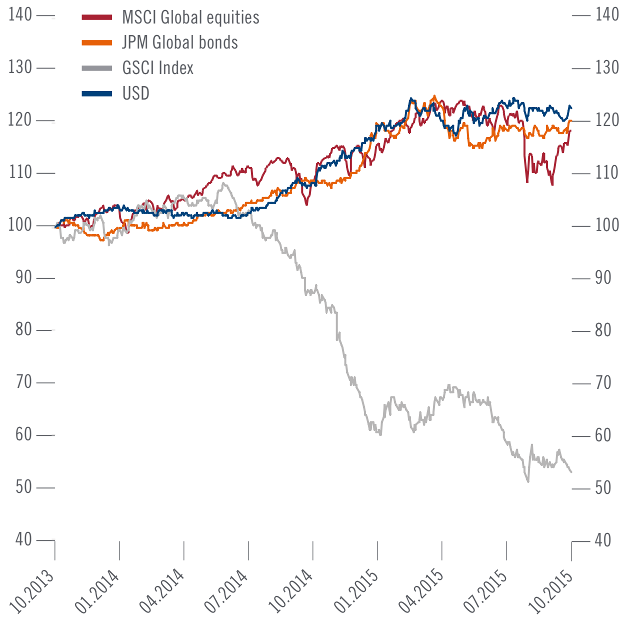
More positively for riskier asset classes is the fact that central banks in other key markets such as Japan and Europe remain firmly in monetary easing mode and there are signs that these policies are working with the extra liquidity filtering through to the real economy.

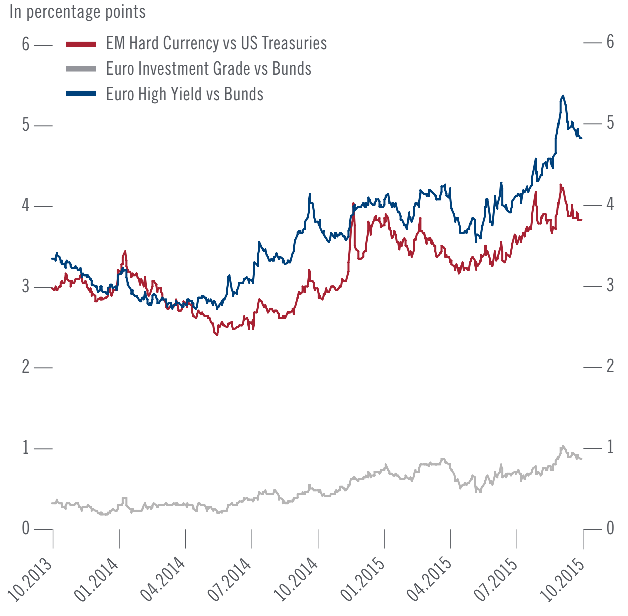
Our **business cycle** readings indicate the world economy remains on a firm footing despite a deceleration in the US and Japan since the second quarter. In the US, consumer sentiment is strong and likely to improve further as the positive impact of lower energy prices on household spending continues to filter through. Furthermore, the property sector is in good shape, with homebuilder sentiment at a 10-year high, mortgage applications rising and rental vacancy rates close to a 20-year low.

The euro zone economy is very resilient and consumption trends remain strong, supported by cheap

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

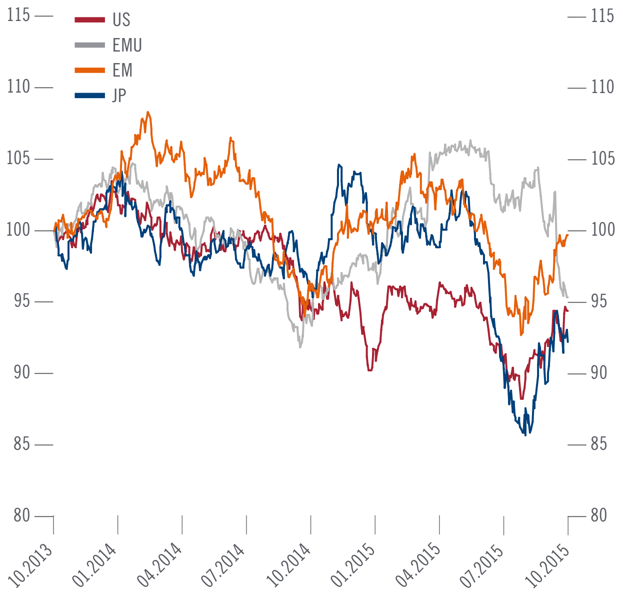
MAJOR ASSET CLASSES

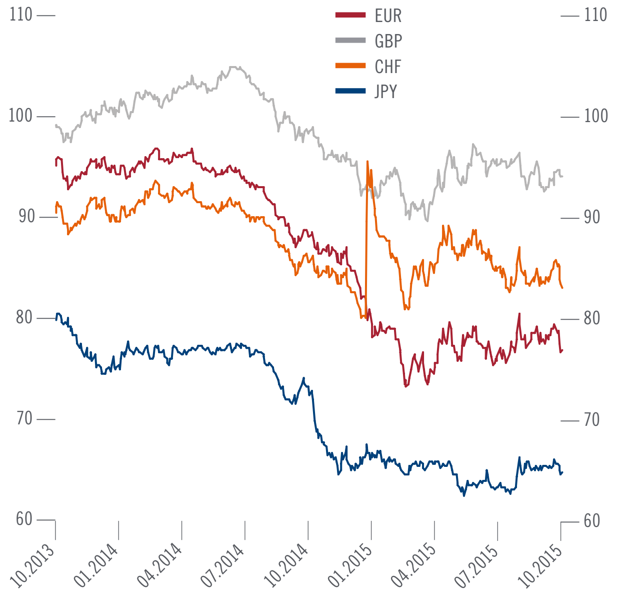

PERFORMANCE: ASSET CLASSES


BONDS: ASSET CLASS SPREADS

In percentage points

EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE


GLOBAL EQUITY SECTOR ROTATION:
PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS


PERFORMANCE: CURRENCIES VS USD

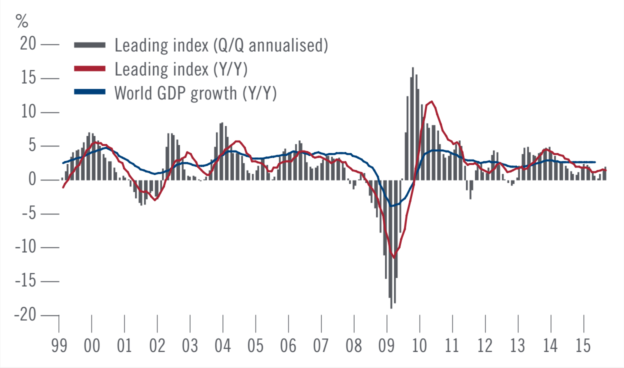
Source: Pictet Asset Management, Thomson Reuters Datastream

RISK BIAS INDICATORS

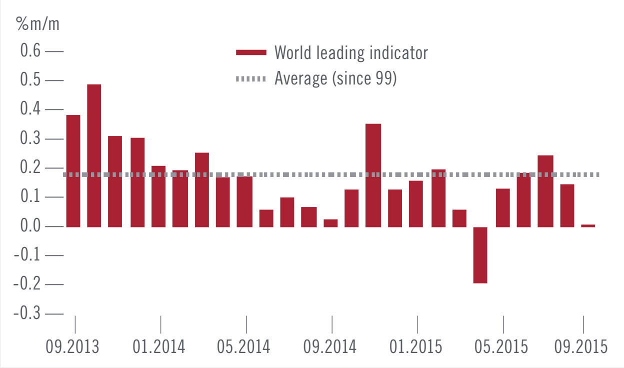
MONTHLY CHANGE		RISK-OFF –		NEUTRAL ○		RISK-ON +	
Maximum change ◀◀◀◀	▷▷▷▷						
					Business cycle		
				Liquidity			
◀				Valuation			
◀				Sentiment			
				PAM strategy			

BUSINESS CYCLE: SIGNS OF STABILITY EMERGE

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

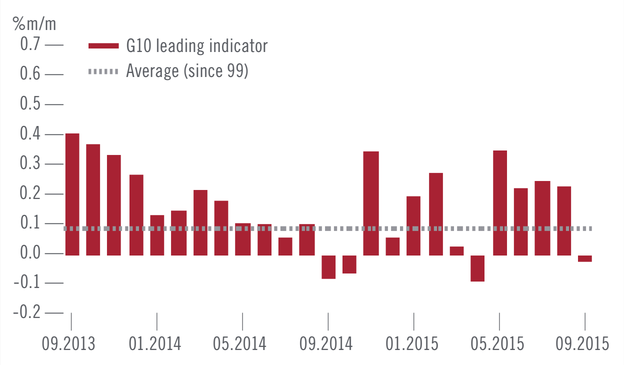


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

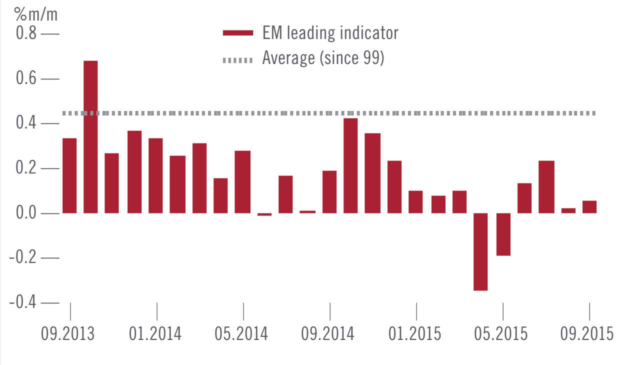


ECONOMIC MOMENTUM MAY BE RECOVERING IN EMERGING MARKETS

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



Source: Pictet Asset Management, Thomson Reuters Datastream

VALUATION: EQUITY MARKETS AND SECTORS

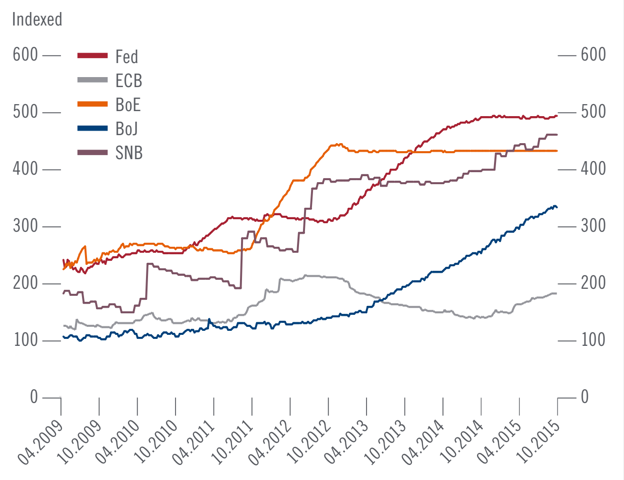
COUNTRIES AND SECTORS

MSCI	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
REGIONS	2015	2016	2015	2016	2015	2016	2015E	2015E	2015E
US	1%	9%	-3%	5%	17.3	16.1	2.6	1.8	2.2%
Europe	0%	8%	-2%	3%	15.7	14.8	1.7	1.2	3.6%
EMU	12%	9%	4%	3%	15.1	14.0	1.5	1.0	3.3%
Switzerland	-5%	7%	0%	3%	17.5	16.6	2.4	2.3	3.2%
UK	-14%	5%	-12%	3%	15.7	15.0	1.8	1.2	4.2%
Japan	20%	7%	1%	3%	14.6	14.0	1.3	0.8	2.0%
EM	-1%	11%	-1%	8%	12.1	11.1	1.4	0.7	3.0%
NJA	4%	8%	-1%	8%	12.3	11.6	1.4	0.7	2.8%
Global	**1%**	**9%**	**-2%**	**5%**	**16.1**	**14.8**	**1.9**	**1.3**	**2.6%**

MSCI	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
GLOBAL SECTORS	2015	2016	2015	2016	2015	2016	2015E	2015E	2015E
Energy	-49%	7%	-26.0%	5.0%	19.9	18.5	1.2	0.8	3.9%
Materials	-15%	12%	-6.7%	1.8%	16.5	15.0	1.5	0.9	3.1%
Industrials	4%	11%	2%	4%	16.4	15.2	2.4	1.0	2.5%
Consumer Discretionary	13%	14%	6%	6%	17.7	15.9	2.7	1.2	1.9%
Consumer Staples	0%	7%	1%	5%	21.3	20.0	3.8	1.3	2.6%
Health care	9%	11%	8%	7%	18.0	16.5	3.7	2.0	1.9%
Financials	11%	7%	6%	5%	12.2	11.6	1.2	1.7	3.3%
IT	6%	9%	4%	4%	16.7	15.5	2.9	2.2	1.7%
Telecoms	8%	7%	4%	4%	15.4	14.6	2.2	1.3	4.2%
Utilities	8%	-2%	-1%	1%	14.4	14.5	1.5	1.0	3.9%
Market	1%	9%	-2%	5%	16.1	14.8	1.9	1.3	2.6%

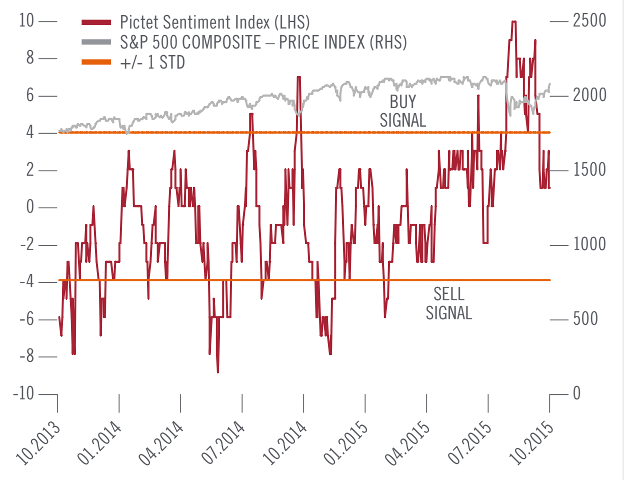
LIQUIDITY: FED ENDS QE BUT MONETARY STIMULUS CONTINUES ELSEWHERE

SIZE OF CENTRAL BANKS' BALANCE SHEETS



SENTIMENT INDICATOR BACK TO NEUTRAL

PICTET SENTIMENT CYCLE INDEX



energy prices. Signs of a pick-up in business investment confirms the extra liquidity provided by the ECB's QE programme is having a positive effect on the real economy. Given that inflation turned negative in September, we expect the ECB to extend QE when it meets in December.

Japan's growth has hit an air pocket. While household spending is holding up some data such as retail sales suggest economic conditions remain fragile. The latest data on investment have also disappointed. Nevertheless, we think that ongoing monetary stimulus, a weak yen, low energy prices and strong labour markets should fuel Japan's economic recovery.

In China, industrial production and construction are stabilising, easing concerns about its economic slowdown. Altough export demand is weak and investment is heading south, the Peoples Bank of China is confronting these problems with looser monetary policy, cutting interest rates further.

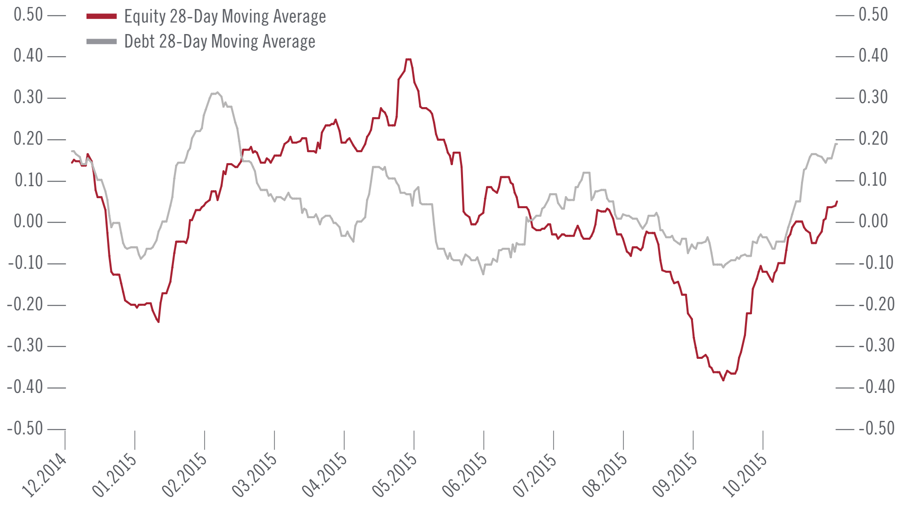
Among other emerging markets, fortunes are mixed. Many have suffered from the decline in commodity prices seen in recent months though some of these, such as Russia, are now showing encouraging signs of rebound. The depreciation of emerging market currencies has also started to fuel a partial recovery, boosting export competitiveness.

In terms of global **liquidity**, a two-speed world has emerged with the US exhibiting a deterioration in monetary conditions and the euro zone, Japan and China seeing the opposite. In the US, liquidity conditions are clearly tightening with a slowdown in the pace of money and credit growth in anticipation of a rate hike.

In contrast, central banks in Europe, Japan, China and other emerging markets are pumping liquidity into their economies to boost growth. In Europe, the positive impact of QE is showing up in bank lending data, with real loan growth turning positive for the first time since 2009 and bank loan surveys suggesting strong demand for credit. Overall, global liquidity conditions remain supportive for riskier asset classes but a rate hike by the Fed could trigger a liquidity squeeze in the US.

EMERGING EQUITIES AND BONDS BACK IN DEMAND WITH FOREIGN INVESTORS SINCE AUGUST 2015

Daily net non-resident purchase of Emerging Market stocks and bonds since December 2014, in USD billion



Source: IIF

Our **sentiment** readings no longer give a 'buy' signal, having shifted to more neutral levels following this month's strong rally in stocks.

Still, while some markets look overbought in the wake of the October bounce, many investors' retain a cautious attitude to risk. Hedge funds' positioning, for instance, remains bearish and trading volumes are still below normal.

Stock **valuations** are back to more neutral levels after the 10 per cent rally in global equity markets over the past month. While lower bond yields should provide support for stocks, uncertainty over the outlook for global corporate earnings is a concern. Across all major regions and sectors, analysts contine to deliver more corporate profit forecast downgrades than upgrades. In the US, although the quarterly earnings season has seen around three quarters of companies beating earnings forecasts, the underlying picture is less positive. Company earnings, sales and margins are contracting on a year-on-year basis, which is very unusual in a recovery. That said, with global equities now trading on a price-earnings ratio of 15 and a price-to-book ratio of 1.9, valuations are in line with the historical norm. Relative to bonds, equities remain cheap – especially in Europe and Japan.

Equity region and sector allocation

Europe and Japan still our preferred regions

In our regional allocation, we keep our preference for Europe and Japan, chiefly on valuation grounds but also because that is where we expect to see the strongest growth in corporate earnings.

Economic resilience, central bank support and cheap currencies remain key factors in the positive outlook for companies in these regions.

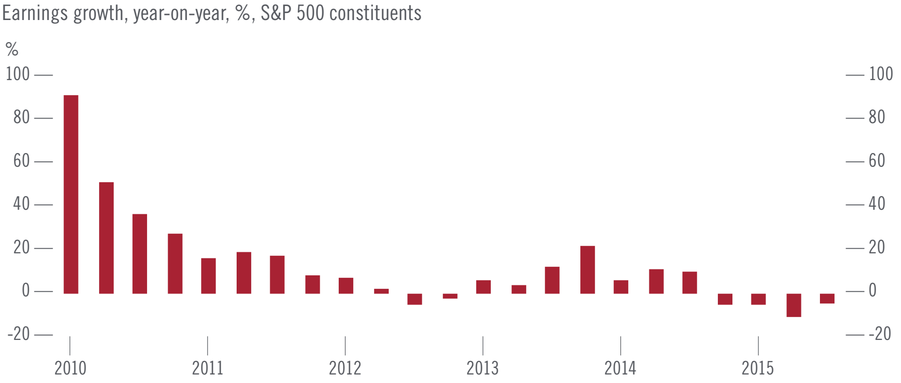
Continued support from the ECB has been central to the recovery in economic and earnings growth in Europe. Recent indications from ECB President Mario Draghi that he may consider expanding the size of its EUR60bn-a-month asset-buying programme, or extend it beyond September 2016, mean these favourable conditions will continue for some time.

In addition, there are signs that Europe's credit markets are beginning to thaw under the effect of QE. The latest ECB's quarterly bank lending survey shows that banks have continued to ease credit conditions in the third quarter; it also reported strong demand from companies and households. The data was particularly bullish in Italy, where 38 per cent more Italian banks reported an easing of conditions among businesses than a tightening.

Japanese stocks exhibit the cheapest valuations among developed markets and earnings growth in corporate Japan is looking very resilient.

Although the economic recovery has been negatively affected by weak external demand, household consumption has remained robust. What is more, weak trade figures should pressure the BoJ into providing more support, which could come in the form of additional monetary stimulus measures.

THE US EARNINGS CYCLE IS LOSING STEAM



Source: Thomson Reuters Datastream

A number of technical signals also support Japanese equity markets. Investor positioning in Japanese stocks is no longer at extremely bullish levels following heavy selling by foreign investors in recent weeks. This limits the scope for a further correction. Longer-term, the Japanese government's plan for a strategic shift of some of the public pension funds' colossal holdings of fixed income into equities constitutes a powerful support for Japanese equity markets.

US equities remain the most expensive market on our scorecard by some margin. The US earnings cycle appears much more advanced than those of other regions with profit growth having already peaked (see chart). We expect to see a much more modest increase in profits in the US than in Europe or Japan over the medium term.

As far as emerging stocks are concerned, the favourable technical factors that motivated our upgrade to neutral last month remain in place. Sentiment towards emerging markets seems to be turning as tentative signs of stabilisation in economic activity have emerged in Asia while liquidity conditions have improved following easing measures by the Chinese central bank. The discount at which emerging market stocks trade to their developed counterparts - 30 per cent based on 12-month forward price-earnings estimates - now seems excessive and we are already seeing investors rebuild their holdings in the asset class.

However, we will need to see further evidence of an economic stabilisation in China to trigger an upgrade to a full overweight.

In terms of sectors, we maintain our moderate cyclical tilt with a preference for cheap cyclical stocks that are less exposed to rising rates. Defensive sectors continue to trade at expensive levels, especially consumer staples, whose price-to-earnings ratios and price-to-book ratios are at 20 and 4 respectivley.

We like financials, which are set to benefit from a rise in US interest rates and an improving outlook for credit in Europe.

Technology stocks exhibit attractive valuations and are better equipped to hold up in a rising rates environment thanks to their large cash balances.

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Fixed Income

EUR government bonds expensive, EM corporates look good

We are making moderate changes to our fixed income positioning, downgrading euro zone government bonds and upgrading emerging market corporate debt to overweight. The downgrade of government debt is linked to excessively high valuations. Recent weeks have seen government bond yields fall in major developed markets in Europe following dovish comments from the ECB.

After year-on-year consumer price inflation turned negative in September and with the euro appreciating since March, Draghi said the ECB is looking at new stimulus measures that could be launched before the year end.

Markets reacted swiftly, with yields on two-year Italian government bonds hitting negative territory for the first time ever (see chart), a notable turnaround in light of the fact that in late 2011, at the height of the euro zone debt crisis, Italian short-term rates were close to 8 per cent. German bond yields also sank to an all-time low at -0.32 per cent.

Against this backdrop, we opted to take some profit on our government bond positions, reducing exposure to European longer duration bonds as we believe valuations for these securities in particular are looking stretched after the recent rally. We also believe that the yield spread between US and German 10 year bonds – now at the widest since 1989 – is not sustainable as US and European growth have converged towards 2 per cent.

Turning to emerging markets, major currencies have staged an impressive recovery with India's rupee, Turkey's lira, the Korean won and the Russian rouble topping the performance tables against the US dollar in October.

However, emerging economies still face considerable risks and developed market growth is not yet translating into strong demand for emerging market exports.

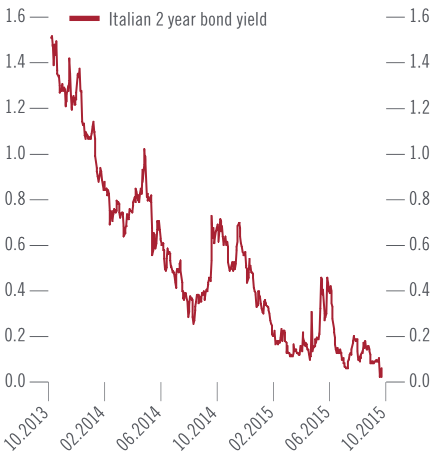
We therefore believe it is too early to jump back into emerging market local currency bonds as this asset class correlates closely with emerging market currencies, which may have further to fall.

Still, opportunities in other emerging market bonds are beginning to appear. We have started to add some exposure to emerging market corporate bonds, such as some Latin American blue chip issuers, which have up to now underperformed significantly and are due a rebound. The shrinking supply of EM corporate debt is also a supporting factor. There is also some value to be found in emerging market US dollar debt as the ability of governments to service their debts is not in question given healthy reserves and low debt-to-GDP ratios.

Olivier Ginguené, Chairman
Pictet Asset Management Strategy Unit

Luca Paolini, Chief strategist
Pictet Asset Management

ITALIAN 2Y BOND YIELDS TURNED NEGATIVE ON 22 OCTOBER



Source: Thomson Reuters Datastream

ABOUT THE PSU

The Pictet Asset Management Strategy Unit (PSU) is the investment group responsible for providing asset allocation guidance across stocks, bonds, cash and commodities.

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
- **sentiment:** Pictet sentiment index (investors' surveys, tactical indicators)

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