PICTET
Asset Management

MULTI ASSET

MONTHLY ASSET ALLOCATION VIEWS

Barometer: Happy new year?

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Pictet Asset Management Strategy Unit

After a gloomy 2018, riskier assets got off to a storming start in the new year. Favourable monetary developments in the US and China should keep equity markets on a stable footing.

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Asset allocation: a central bank backstop

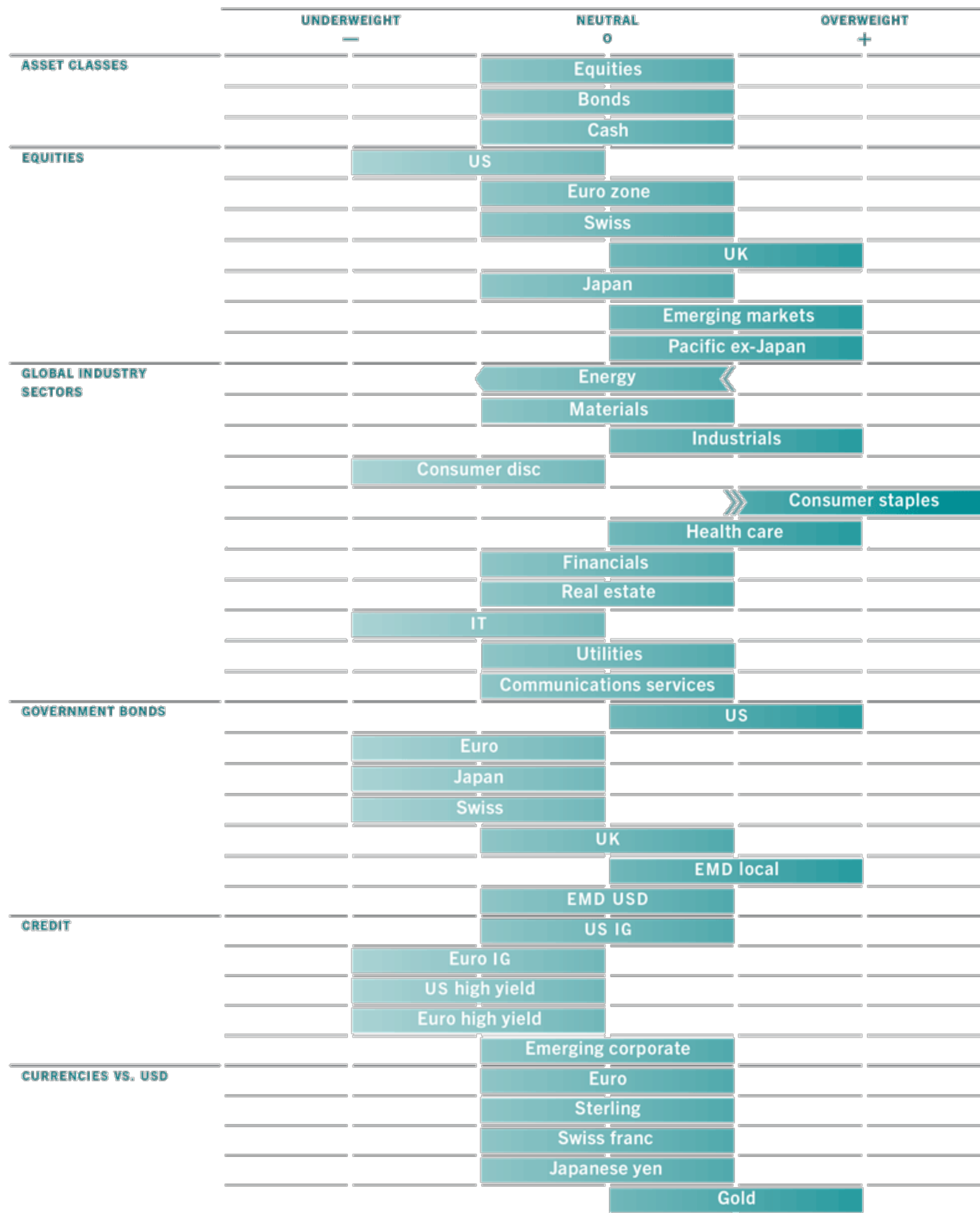
The global economy is cooling. Concerns about a full-blown trade war between the US and China have led to a significant deterioration in business confidence and economic activity, particularly in the developed world.

It's not all doom and gloom, though. Central banks are once again taking action to support growth.

The US Federal Reserve has signalled a halt to rate increases; it might also slow the pace of sales in its bond portfolio. What is more, China has implemented monetary stimulus on top of fiscal measures to stabilise economic growth. Together, the actions of the world's most powerful central banks should help calm investor nerves following the market rout at the end of 2018.

Still, central bank action cannot completely eliminate investment risks: tensions between the US and China will linger for some time to come.

Taking all this into account, we have decided to maintain a neutral stance on equities and bonds.



Source: Pictet Asset Management

Our **business cycle** analysis shows economic growth is slowing in the developed world.

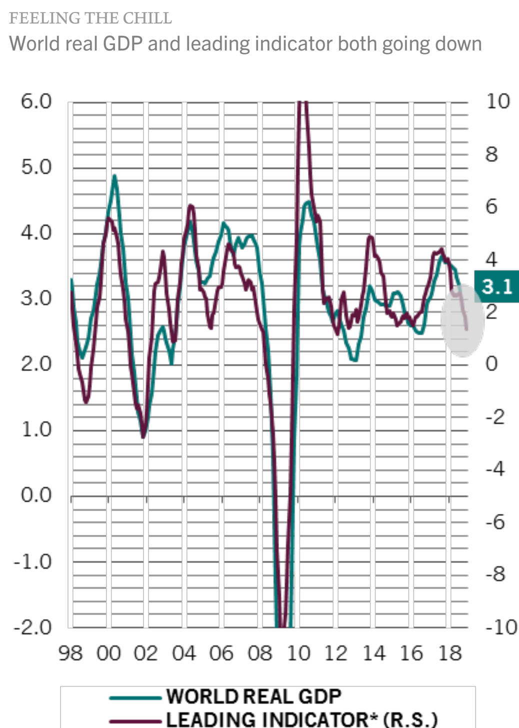
Our leading indicators point to real annualised global GDP growth of 2.6 per cent by end-March – that would be half a percentage point lower than the pace seen in the preceding six months to September.

The impact of Sino-US trade tensions is largely to blame. Exports and industrial production are falling sharply even though real interest rates and inflationary pressures are low.[1]

The US economy is experiencing a sharp slowdown, with its manufacturing activity in December registering the biggest monthly drop since late 2008, when the economy was in the throes of a recession.

The euro zone seems to be going from bad to worse – its industrial production is contracting at an annual rate of 3.2 per cent while Italy fell into recession for the first time in five years.

Emerging economies are faring much better, thanks to efforts by China to stabilise growth. Beijing has implemented a package of monetary, fiscal and trade measures to underpin the economy; the size of the stimulus is equivalent to 1.1 per cent of GDP. Latin America is also a bright spot. Growth there is accelerating, with Brazil's new president Jair Bolsonaro injecting fresh optimism with his pro-market reforms.



*Weighted average of 38 individual countries leading indicators. Source: Thomson Reuters Datastream, data covering period 01.01.1998 – 31.12.2018

Our **liquidity** readings show monetary authorities in the US and China are beginning to respond to a growth scare.

Most notably, China's monetary authorities have implemented as many as 15 new measures in the past four months to underpin growth and improve the flow of credit to households and small companies. On top of cutting reserve requirements, or the amount of cash that banks have to hold as reserves, the People's Bank of China is setting up a central bank bill swap (CBS) programme, designed to encourage banks to replenish capital through perpetual bond issuance and spur lending.

Our readings for Europe are less encouraging, however. There, the European Central Bank has stopped buying new assets at a time when the region's fragile economy faces risks from Brexit and US-China trade tensions. Making matters more complicated, any attempt by the ECB to resume its bond buying campaig before President Mario Draghi leaves office in June is likely to face formidable political hurdles.

Our **valuation** scores remain neutral for riskier asset classes, although a number of asset classes look cheap.

UK stocks are among the most attractive asset classes. Not only does the UK market boast a large number of large-cap defensive companies, but it also trades at a high dividend yield of 5 per cent, compared with the global average of 3 per cent.[2]

US stocks, by contrast, are overvalued. Even after a recent sell-off, US stocks remain expensive based on their cyclically-adjusted price-earnings multiples. Moreover, we expect more corporate earnings downgrades from analysts. Our forecast of 2019 for 3 per cent earnings per share growth in the US is half the consensus level.

In fixed income, emerging local currency debt offers the best value, especially as the region's currencies trade at around 25 per cent below what we consider to be a fair value. German bunds are the most expensive bonds on our scorecard.

Our **technical** and sentiment analysis also supports a neutral stance on equities. Equity flows indicate that investors have been cautious in rebuilding their positions after the year-end sell-off, while our indicators point to continued volatility in the equity markets in the weeks ahead.

[1] Average of 7 nominal interest rates (policy rates, three-month interest rates, 2Y, 5Y & 10Y swap rates, 5Y and 10Y government bond yields), CPI deflated, GDP weighted for 10 developed markets. Source: Pictet Asset Management, CEIC, Thomson Reuters Datastream
[2] MSCI All-Country World Index, data as of 31.01.2019

02

Equity sectors and regions: value in emerging markets and UK

Whether it's valuations or sentiment, conditions for the global equity market don't look particularly inspiring.

Drill a bit deeper and there are plenty of risks, including heightened jitters over economic growth in developed markets, uncertainty over Fed policy and ongoing trade disputes. It is no coincidence that expectations for corporate profits are heading lower – worldwide, there are now about five analyst earnings downgrades for every upgrade.

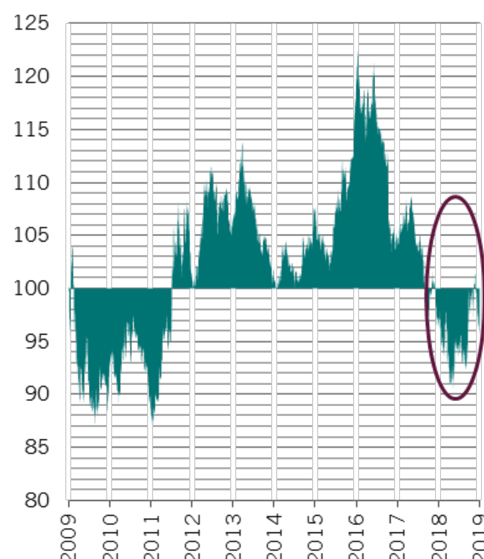
Our models suggest company earnings will grow 5 per cent this year globally – not the end of the world by any means, but down sharply from the 15 per cent seen in 2018 and below the current consensus analyst estimate of 7 per cent.

We believe that the best way to guard against the possibility of a market correction is by shifting to a more defensive sector allocation.

Firstly, that means downgrading energy stocks to neutral. The price of their underlying asset – oil – has surged some 20 per cent in the past month and we struggle to see why it would head much higher than the current levels of around USD60 a barrel, particularly at this advanced point in the global economic cycle. Technical indicators are also turning red for the energy sector, particularly in terms of market breadth – less than 20 per cent of stocks in the sector are trading above their 20-day moving average.

Our defensive mindset is also reflected in underweight positions in expensive cyclical consumer discretionary and IT sectors.

DUE FOR A CATCH-UP
Consumer staples performance relative to MSCI ACWI



Source: Thomson Reuters Datastream. Data covering period 29.01.2009-29.01.2019

Conversely, we have upgraded consumer staples stocks to overweight from neutral. According to our valuations model, such firms are among the cheapest defensive stock investments (see chart). Furthermore, consumer staples have relatively high exposure to emerging markets – a notable bright spot in the otherwise lacklustre global economy.

Indeed, we are fairly upbeat on emerging market-linked stocks in general, as growth there is holding up much better than in the rest of the world. Emerging market equities also boast attractive valuations and should benefit both from a pause in the Fed's tightening cycle and from China's reflation efforts.

We are also overweight UK-listed stocks, which are the cheapest in our valuation scorecard. Although Brexit is a concern, UK bluechips are attractive on several fronts. Not only do larger-cap UK equities offer investors exposure to many established international firms, but also to a relatively high number of defensive stocks that typically do well in the latter stages of the economic cycle. Plus UK shares trade at an attractive dividend yield of 5 per cent – in fact shareholder payouts from UK companies hit a record last year.

In contrast, we are cautious on the US, whose stretched valuations should concern investors at a time when analysts are cutting earnings forecasts.

03

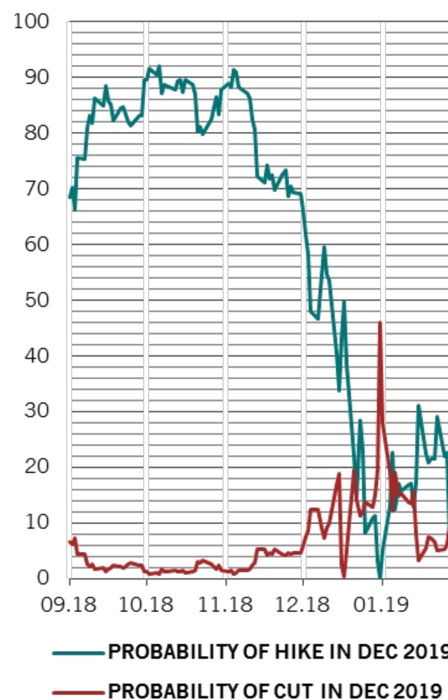
Fixed income and currencies: the doves are back in town

With the Fed pivoting on its policy heels, the outlook looks positive for US Treasury bonds and local currency emerging market debt, and we remain overweight both asset classes.

At its latest policy meeting, the US central bank made clear its determination to keep its tightening cycle on ice in the absence of a significant pick-up in US inflation. Further interest rate hikes are off the agenda for now, while Fed chairman Jay Powell also signalled the board was open to slowing the pace at which it shrinks its balance sheet – in sharp contrast with only a few months ago when he said the programme would be on autopilot.

The market's interest rate forecasts have shifted commensurately – from expecting almost three quarter point hikes during 2019 to – marginally – now anticipating that the next move in Fed funds will be down. This softening of expectations reinforces our positive stance on US Treasury bonds. Although yields have come down substantially from last autumn's highs – the 10 year's, for example, is down to 2.72 per cent from a recent peak of 3.23 per cent in October – there's scope for them to come down further if the Fed starts to ease policy in the face of an economic slowdown.

RE-RATING
Market implied probability of a change in US Fed funds rate after December 2019 policy meeting



Source: Thomson Reuters Datastream. Data from 01.09.2018 to 30.01.2019

Meanwhile, there's the further possibility that the US Treasury could dip into the General Account it holds at the Fed to fund government spending in the event of another government shutdown. The combination of a more dovish Fed and these liquidity injections could well put the US dollar under pressure. That's particularly relevant for emerging market currencies, which remain exceptionally cheap – indeed, near the cheapest they've been during the past two decades. This underpins our positive stance on local currency emerging market debt. January was the best month for the asset class in more than two years after being beaten down during 2018.

We continue to stick to an overweight on gold. A halt to Fed tightening at a time when the Chinese central bank is once again stimulating its economy by using some extraordinary policy measures, suggests it's a good time to hold a hedge against both market volatility, geopolitical risks and a sharp fall in the dollar.

Finally, we remain very pessimistic on the tactical and strategic outlook for corporate bonds. We think that the tightening of their yield spreads over the past month – for US high yield, they've come down around 100 basis points to 440 basis points, which is well below historic average – is not sustainable given a peak in company earnings growth, very high corporate leverage and deteriorating credit ratings.

04

Global markets overview: everything's back up

2018 might have been a bust for most asset classes, but the new year started with a bang. World equities surged more than 7 per cent in local currency terms[3] during January having dropped by as much over the previous 12 months. Meanwhile, global bonds extended their December rally by tacking on another 0.7 per cent.

There was relief that China was stepping on the policy accelerator again and at the Fed's U-turn on how much liquidity it should drain from economy. Unsurprisingly, US equities did very well, with the MSCI US Index up more than 8 per cent on the month.

In equity sectors, cyclical stocks broadly outpaced defensives, with, for instance, IT and consumer discretionary gaining more than 8 per cent on the month while consumer staples, utilities and health care up by roughly half as much.Commodity prices surged, rising 9 per cent in January in large part thanks to a 13 per cent jump in oil prices. That, in turn, lifted the energy equities sector by some 9 per cent on the month.

MSCI AC World – total return index

Source: Thomson Reuters Datastream. Data covering period 27.01.2017-29.01.2019

Emerging market assets also registered a stellar rebound after an exceptionally grim year, thanks in part to a slightly softer dollar, down 0.6 per cent in January, and optimism about a Chinese economic recovery and easing trade fears. Emerging Asia equities, for example, jumped 7 per cent in January, going a long way to recouping their near 13 per cent slump in 2018, while emerging market local currency and dollar debt rallied some 5 per cent (in dollar terms) and 4 per cent respectively.

Corporate bonds also did well after last year's wobble. US high yield in particular stormed to a 4.5 per cent gain, while European high yield's more modest 2 per cent rise reflected a more muted outlook for European economies. Equity investors might have been hopeful about growth, but that didn't worry bondholders, as global inflation remains subdued. Nonetheless, investors looked to gold for some insurance against things getting out of hand, lifting the precious metal 3 per cent during the month.

[3] All performance is in local currency terms unless otherwise stated.

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In brief

BAROMETER FEBRUARY 2019

Asset allocation

The global economy is slowing but central banks are providing support. Keeping neutral stance on equities and bonds.

Equity regions and sectors

Turning more defensive on developed market sectors, we downgrade energy to neutral and upgrade consumer staples to full overweight. We remain attracted to emerging market equities.

Fixed income and currencies

The Fed's U-turn on policy tightening supports our overweight stance on Treasury bonds, emerging market local debt and gold.

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