

**MULTI
ASSET**

MONTHLY ASSET ALLOCATION VIEWS

Barometer: Bulls beware

August 2019

Pictet Asset Management Strategy Unit

Riskier asset classes have rallied on hopes that the monetary taps will open once more. But the stimulus will be more modest than markets expect.

Table of contents

- 01** Asset allocation: priced for perfection

- 02** Equity sectors and regions: seeing value in financial stocks

- 03** Fixed income and currencies: defensive assets in short supply

- 04** Global markets overview: Fed caution fails to dent rally

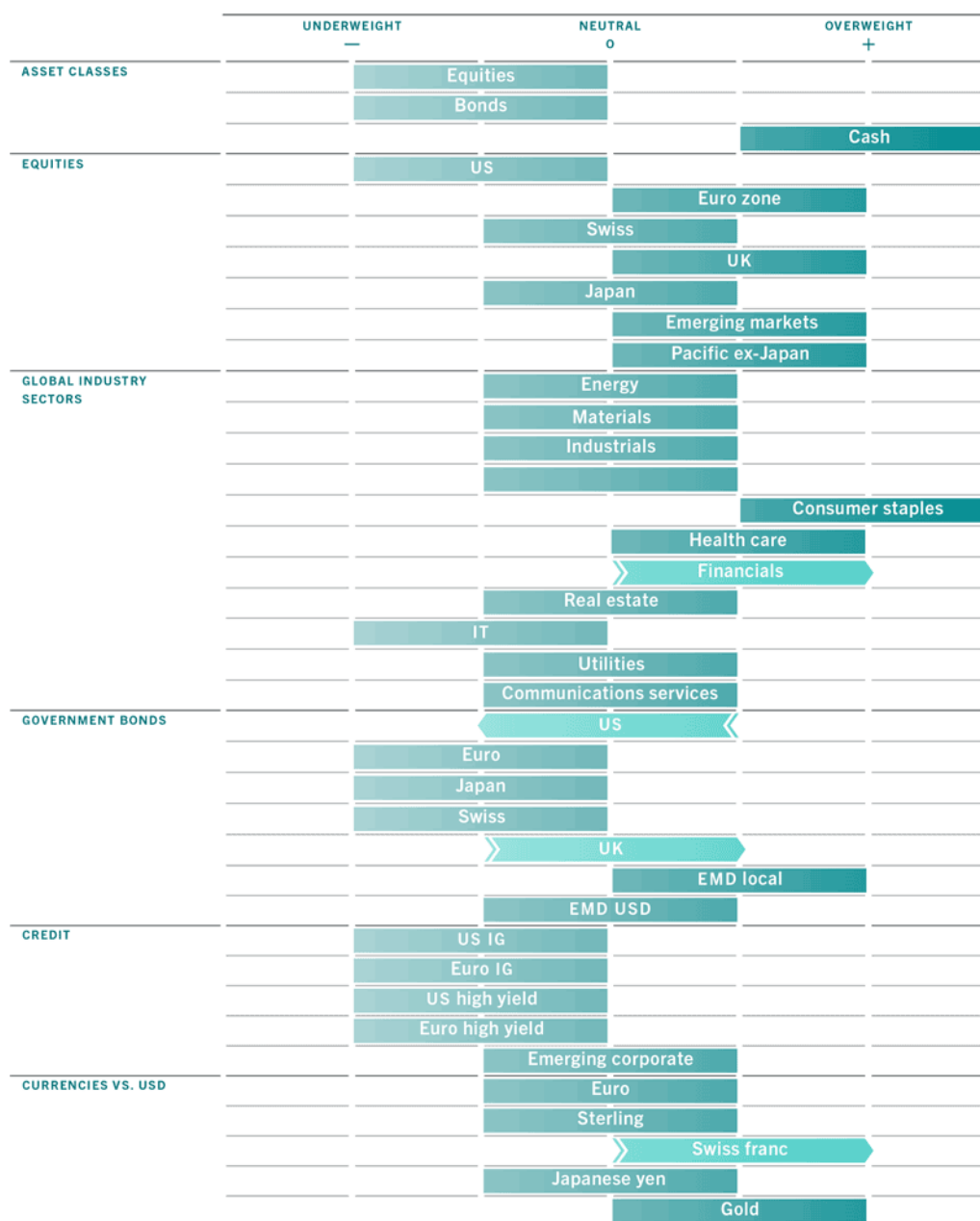
- 05** In brief

Asset allocation: priced for perfection

Global equity markets have raced to all-time highs as investors have bet that central banks around the world will open the monetary taps to arrest an economic slowdown.

However, we don't think economic conditions justify the amount of stimulus financial markets have discounted. While a recent deterioration in economic data suggests that world growth will come in at a below-potential at 2.2 per cent this year, a slowdown of this magnitude doesn't warrant an aggressive easing of monetary policy.

For these reasons, we remain cautious on equities – and have therefore kept our underweight stance on the asset class. It's hard to be positive on bonds either, at a time when a record USD13 trillion of global debt is yielding below zero. We maintain our overweight in cash.



 Pictet Asset Management

Our **business cycle** analysis shows the global economy is experiencing a broad-based slowdown, with export-sensitive industrial and manufacturing sectors in particular continuing to come under pressure thanks to disruptions in global trade.

Nowhere has this been more apparent than in the US. That said, consumer demand is resilient and labour markets remain tight. We expect the US Federal Reserve to ease monetary policy a little more following its July 25 basis point rate cut, but to limit itself to a more modest insurance policy than financial markets are discounting.

Market expectations for an additional 100 basis points of rate reductions are too aggressive.

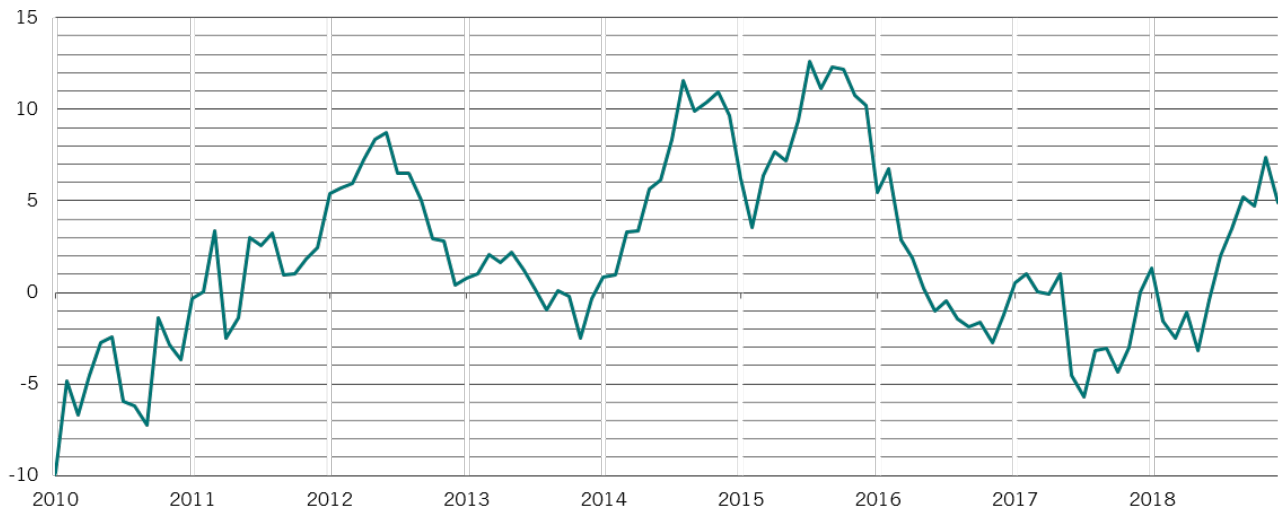
The outlook for the euro zone economy is more positive. On a three-month rolling basis, the region's leading indicator has risen for four months in a row, thanks to improvement in industrial production in France and Italy, better consumer sentiment and tighter labour markets.

In emerging markets, meanwhile, China's economy posted its slowest growth in 27 years in the second quarter, yet its service sector has performed relatively well. But overall, growth in the emerging world remains relatively healthy.

Our **liquidity** indicators suggest taking a cautious stance on risky assets. According to our model, the current price-earnings (P/E) ratio of the S&P 500 index implies the world's central banks are going to deliver cash injections of as much as USD1.8 trillion this year – way above the annual average of USD1.2 trillion since the 2008 financial crisis. Such a stimulus would require a simultaneous monetary easing across the US, euro zone Japan and China - a scenario we consider unlikely.

Excess liquidity of three major economies – which we calculate as the difference between the rate of increase in money supply and nominal GDP growth - has likely peaked at around current levels of 3.6 per cent (see chart), which should put downward pressure on P/E multiples over the near term.

REACHING A PEAK
G3 excess liquidity growth, %, annual



📷 G3 excess liquidity calculated as broad money minus value of domestic industrial production growth over the past 6 months in the US, euro zone and Japan. Source: Refinitiv, data covering period 01.06.2010 - 31.05.2019

Our **valuation** model indicates equities are neither expensive nor cheap at a global level. Within regions, however, the US market still is the most expensive as equities there trade at a premium of 30 per cent to world stocks on a cyclically-adjusted P/E basis. In contrast, Japanese and UK stocks remain cheap relative to global stocks.

Bonds continue to be eye-wateringly expensive, however, with real yields on global debt - as measured by the JPMorgan Government Bond Index - falling to a record low of minus 1 per cent. Within fixed income, emerging local currency debt looks good value, particularly as the developing world currencies are undervalued versus the dollar by as much as 25 per cent.

Our **technical** indicators suggest that neither equities nor bonds are a 'buy' at this point. Curiously, the recent rally in equities has been accompanied by only very modest flows into mutual equity funds. That said, speculative positioning in stocks among professional investors looks excessively bullish, with asset manager net holdings in S&P 500 futures at elevated levels.

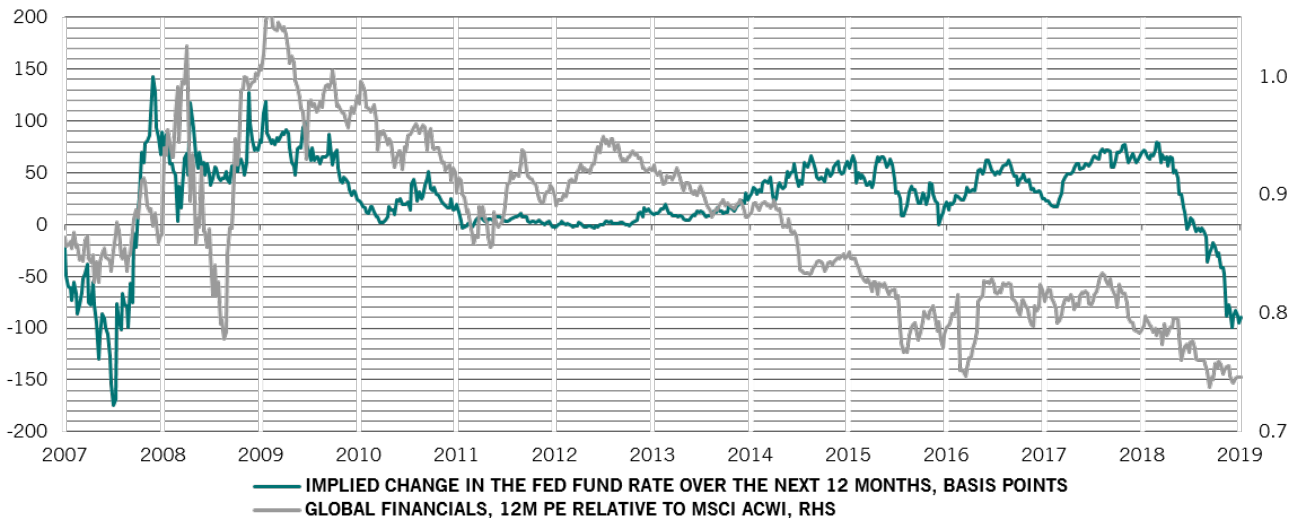
Equity sectors and regions: seeing value in financial stocks

With the world economy slowing and corporate earnings growth deteriorating, we continue to prefer areas of the stock market that are trading at valuations that we consider fair to cheap.

Financials fall into this category. Valuations are attractive – financial stocks are among only a handful of asset classes trading below their 20-year trend on either a price to book or price to earnings basis.

Technical signals are also positive, with 72 per cent of stocks in the MSCI World Financials index trading above their 200 day moving average. Allocating capital to financial stocks also makes sense given that we believe interest rate cuts in both the US and elsewhere will prove to be shallower than the market is expecting, which would be good news for banks' lending margins.

FINANCIALS COULD BENEFIT IF RATE CUT EXPECTATIONS ARE SCALED BACK



Source: Refinitiv, data covering period 23.07.2007 - 29.07.2019

Elsewhere, we retain a fairly defensive sector allocation with an underweight in IT – where earnings growth is peaking – and an overweight in consumer staples.

Separately, we remain underweight the US, which offers one of the worst combinations of value (it is the most expensive region in our grid) and growth prospects. The potential for a sell-off looks all the more likely considering investors' fairly elevated net positioning in S&P 500 futures contracts.

Earnings momentum, measured by net upgrades as a percentage of total profit forecast revisions for MSCI World constituents have deteriorated materially.

Corporate margins remain under pressure globally however analysts' expectations do not reflect this. We expect corporate earnings to continue to deteriorate and to undershoot consensus forecasts: our models suggest 1 per cent

earnings per share growth for next 12 months against analyst consensus of around 8 per cent.

One bright spot is the euro zone, whose economic prospects are showing significant improvement. Our leading indicator has risen month-on-month for four months in a row and is now in positive territory, led by France and Spain. Consumer sentiment and improving labour market conditions suggest that private consumption remain supportive. Another positive are earnings prospects. Reporting second quarter results, more than 90 per cent of European companies raised or maintained their profit forecasts for the remainder of the year, according to Barclays.

We also remain overweight on emerging market and UK stocks. The UK market looks attractive due to very cheap valuation, caused by Brexit worries – at 5 per cent the dividend yield versus global equities which offer 2.5 per cent. In the emerging world, meanwhile, not only are stock valuations cheap, but analyst forecasts for corporate profit growth have been increasing in recent weeks, outstripping those for developed market firms.

Fixed income and currencies: defensive assets in short supply

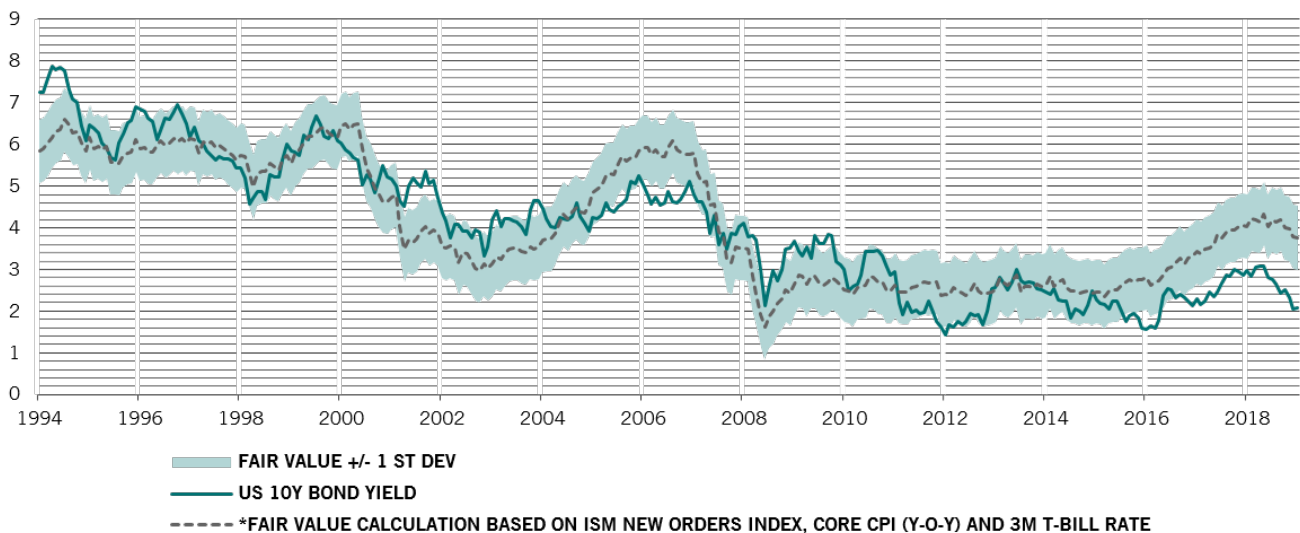
There was a time when developed market bonds could be relied upon to dampen the volatility of an investment portfolio. No longer. With some USD13 trillion of such securities trading at negative yields – the real yield offered by the JPMorgan global government bond benchmark is at a record low of minus 1 per cent – we cannot justify holding a larger-than-benchmark weighting over three to six months in any of the fixed income assets that make up the investment-grade bond market.

We reduced our weighting on US Treasuries to neutral this month.

In our view, the foundations upon which the bond market's rally has been built look increasingly shaky.

For one thing, expectations for interest rate cuts are overly optimistic. In the US, Federal funds futures now discount a fair chance of three more 25 basis point rate cuts over the next 12 months. To us, that is much more aggressive than the insurance policy the Fed will put in place: history shows the US central bank only delivers rate reductions of 100 basis points or more when the economy is contracting. What is more, US inflationary pressures are building.

US GOVERNMENT BOND YIELDS HAVE FALLEN TOO FAR
10-year bond yield, %, vs fair value



Source: Pictet Asset Management, data covering period 31.12.1993-30.07.2019

The technical indicators we monitor also raise a red flag. Investor positioning in world government bonds in particular suggest the asset class is now "overbought", increasing the probability of a sell-off over the near to medium term. Valuations don't offer support either: of the four most expensive asset classes on valuation scorecard, three are fixed income. And global government bonds, US Treasuries and US investment grade bonds are each trading some 1.5 standard deviations above their long term trend.

We have upgraded UK gilts to neutral, which should find support from the growing risk of a "no deal" Brexit.

What is broadly true for government and investment grade corporate bonds, also holds for high yield debt in both Europe and the US, where we hold lower than index weightings.

Prospects for emerging market sovereign bonds are brighter, however, particularly those denominated in local currency. Yields remain attractive while emerging market currencies – a key source of return for local currency bonds – are undervalued versus the dollar by more than 20 per cent even though currencies such as the Russian rouble, South African rand and Brazilian real have gained more than 5 per cent against the greenback this year.

Separately, we have increased our weighting on the Swiss franc to overweight. In a period in which advanced economies are keen to devalue their currencies, the franc is likely to hold up best.

Global markets overview: Fed caution fails to dent rally

After a June that saw both equities rip higher on ever more dovish noises from the Fed, markets turned quieter, if still bullish, as the central bank's July meeting loomed.

On the last day of the month, the Fed delivered what many considered was a "hawkish" rate cut. That's to say, the central bank met expectations by lowering its funds rate by a quarter point, but the market was left confused when chair Jerome Powell's suggested the move merely represented a mid-cycle policy tweak rather than the start of a more concerted round of cuts.

Still, global equities, as measured by the MSCI World equity index managed a rise of 1 per cent on the month, for a gain of some 17 per cent so far this year. Bonds did nearly as well, up more than 0.5 per cent, according to the JPMorgan global bond index. Once again, US equities were towards the front of the field, picking up 1.5 per cent to show a gain of more than 20 per cent on the year. But so far this year, Swiss stocks have been the stand-out performers up nearly a 25 per cent. IT remains the market's darling, up 3.1 per cent on the month and nearly 30 per cent on the year so far, while energy and materials lagged as commodities struggle amid a squeeze on trade. Health care also struggled during the month.

GETTING HOT
MSCI All-Country World Equity Index



Source: Refinitiv, data covering period 28.07.2014 - 29.07.2019

Despite uncertainty over how dovish the Fed might turn out to be, bonds remain supported by expectations of easier monetary policy across the globe. The European Central Bank is gearing up for its own set of measures to support flagging growth and prop up disappointingly weak inflation. Ditto for the Bank of Japan and some other central banks.

While government bonds have rallied, so too has emerging market debt.

Emerging market bonds have been particularly strong performers, with local currency bonds up more than 9 per cent and dollar-denominated bonds up some 12 per cent on the year, JPMorgan indices show. EM corporate bonds, meanwhile, have gained 11 per cent since the start of the year.

In the foreign exchange markets, it has continued to be a story of US dollar strength. Sterling has done particularly badly, down about 4 per cent on the year so far against the greenback, with almost the whole of that loss coming in July as investors responded to new prime minister, Boris Johnson's insistence that Brexit will happen on October 31, whether or not a deal has been agreed with the European Union.

BAROMETER AUGUST 2019

Asset allocation

We keep our underweight stance in stocks and bonds and remain overweight in cash.

Equity regions and sectors

We upgrade financials to overweight as market expectations of US rate cuts look excessive.

Fixed income and currencies

We downgrade Treasuries to neutral; we are also neutral on UK gilts.

Important legal information

This marketing document is issued by Pictet Asset Management. It is neither directed to, nor intended for distribution or use by any person or entity who is a citizen or resident of, or domiciled or located in, any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation. Only the latest version of the fund's prospectus, the KIID (Key Investor Information Document), regulations, annual and semi-annual reports may be relied upon as the basis for investment decisions. These documents are available on assetmanagement.pictet.

This document is used for informational purposes only and does not constitute, on Pictet Asset Management part, an offer to buy or sell solicitation or investment advice. It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. The effective evolution of the economic variables and values of the financial markets could be significantly different from the indications communicated in this document.

Information, opinions and estimates contained in this document reflect a judgment at the original date of publication and are subject to change without notice. Pictet Asset Management has not taken any steps to ensure that the securities referred to in this document are suitable for any particular investor and this document is not to be relied upon in substitution for the exercise of independent judgment. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Before making any investment decision, investors are recommended to ascertain if this investment is suitable for them in light of their financial knowledge and experience, investment goals and financial situation, or to obtain specific advice from an industry professional.

The value and income of any of the securities or financial instruments mentioned in this document may fall as

well as rise and, as a consequence, investors may receive back less than originally invested. Risk factors are listed in the fund's prospectus and are not intended to be reproduced in full in this document.

Past performance is not a guarantee or a reliable indicator of future performance. Performance data does not include the commissions and fees charged at the time of subscribing for or redeeming shares. This marketing material is not intended to be a substitute for the fund's full documentation or for any information which investors should obtain from their financial intermediaries acting in relation to their investment in the fund or funds mentioned in this document.

EU countries: the relevant entity is Pictet Asset Management (Europe) S.A., 15, avenue J. F. Kennedy, L-1855 Luxembourg

Switzerland: the relevant entity is Pictet Asset Management SA , 60 Route des Acacias – 1211 Geneva 73

Hong Kong: this material has not been reviewed by the Securities and Futures Commission or any other regulatory authority. The issuer of this material is Pictet Asset Management (Hong Kong) Limited.

Singapore: this material is issued by Pictet Asset Management (Singapore) Pte Ltd. This material is intended only for institutional and accredited investors and it has not been reviewed by the Monetary Authority of Singapore.

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.

Pictet Asset Management Inc. (Pictet AM Inc) is responsible for effecting solicitation in North America to promote the portfolio management services of Pictet Asset Management Limited (Pictet AM Ltd) and Pictet Asset Management SA (Pictet AM SA).

In Canada Pictet AM Inc. is registered as Portfolio Manager authorised to conduct marketing activities on behalf of Pictet AM Ltd and Pictet AM SA. In the USA, Pictet AM Inc. is registered as an SEC Investment Adviser and its activities are conducted in full compliance with the SEC rules applicable to the marketing of affiliate entities as prescribed in the Adviser Act of 1940 ref. 17CFR275.206(4)-3.