



**MULTI
ASSET**

MONTHLY ASSET ALLOCATION VIEWS

Barometer: Irrational exuberance

July 2019

Pictet Asset Management Strategy Unit

Expectations for US interest rate cuts have triggered a rally in risky assets, but investor hopes for aggressive monetary easing are likely to be dashed.

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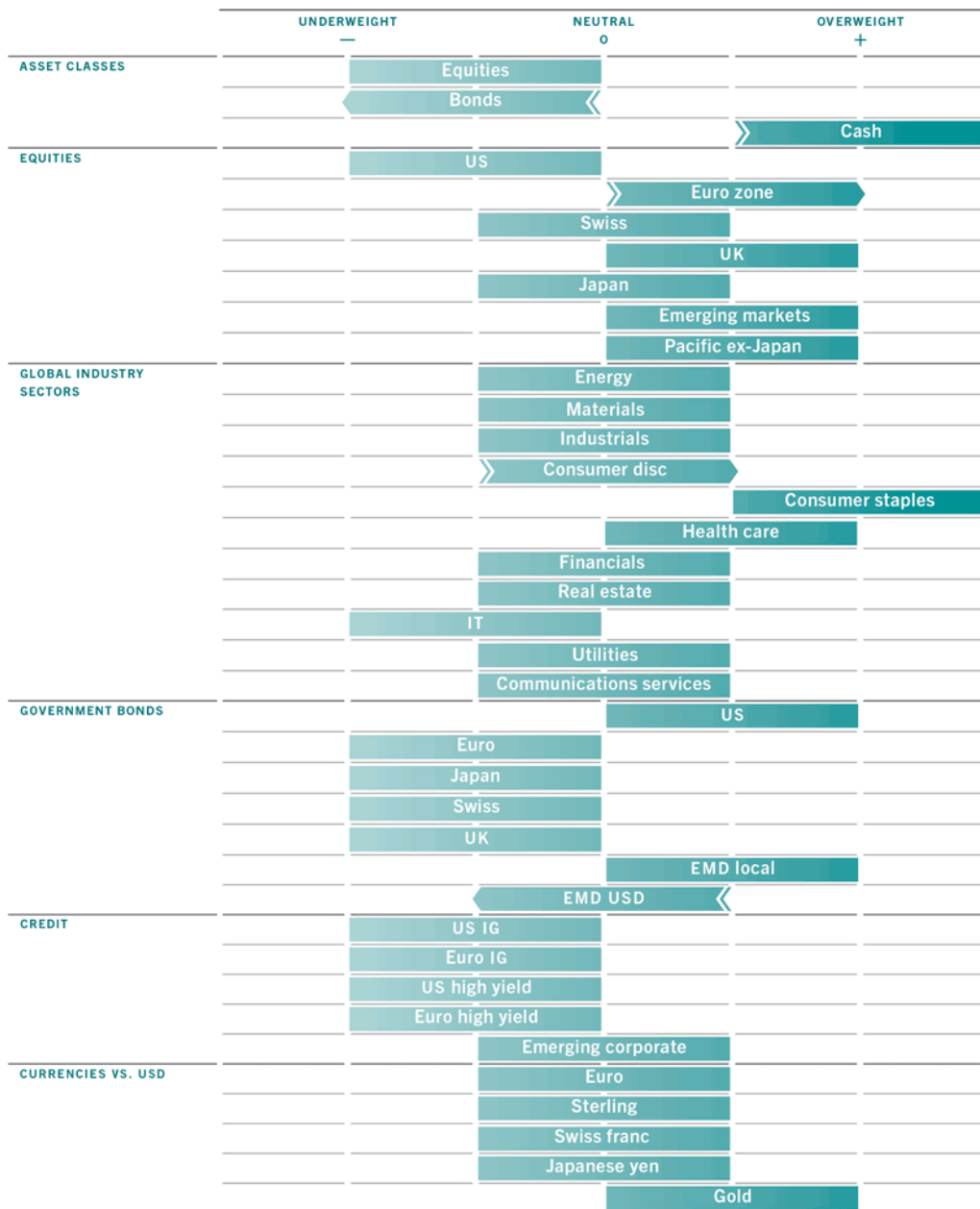
Asset allocation: too far too fast

With a slowing global economy at risk of being undermined further by the various trade spats initiated by US President Donald Trump, the US Federal Reserve once again made its presence felt in global markets. One after another, Fed policymakers indicated that the central bank was prepared to insure against a serious downturn with pre-emptive rate cuts, helping lift global equities and bonds by some 6 per cent and 1 per cent respectively on the month.

The market is now discounting a full percentage point of rate cuts over the coming 12 months, starting with a reduction in July. Not only is the S&P 500 index back near record highs, but more than USD12 trillion of global debt is trading at negative yields.

In our view, however, the euphoria over US interest rate cuts is overdone – the first rate cut could well be delayed until September.

As a result we're downgrading bonds and are now underweight both fixed income and equity; we have also raised our weighting to cash.



Source: Pictet Asset Management

The Fed's new dovishness has to be set against a US economic backdrop that remains relatively positive.

True, our own leading indicator has been weakening since the end of last year. But lately, construction activity has picked up, employment remains robust and car sales are showing sign of a tentative rebound.

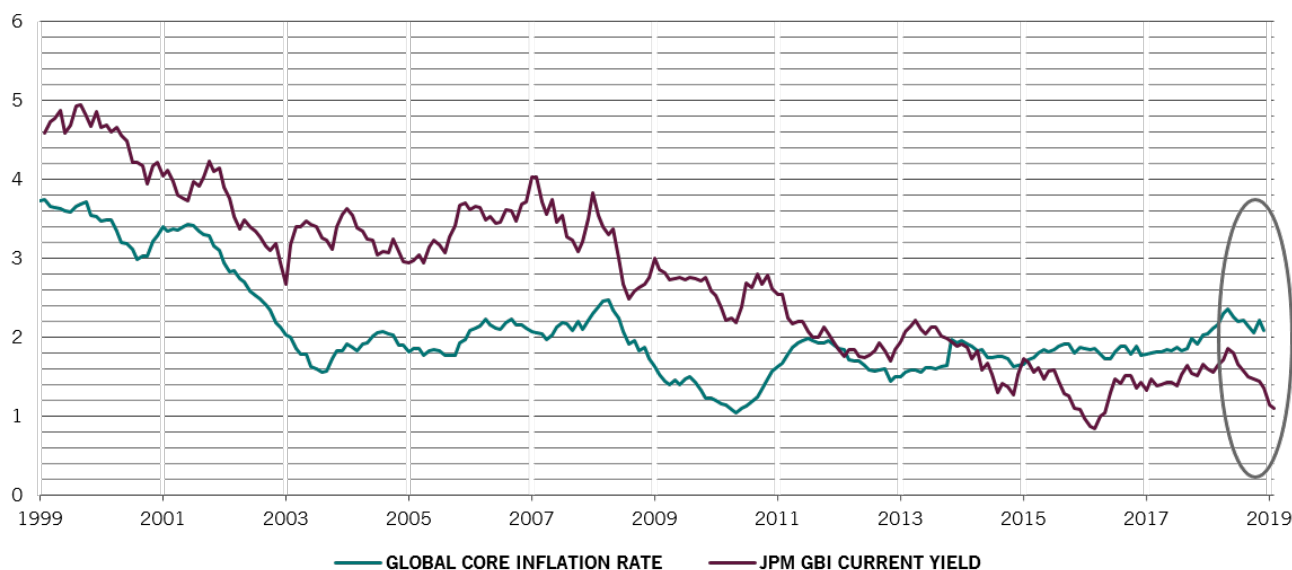
While our **business cycle** indicators continue to show the global economy is slowing, they don't suggest a hard landing. China-US trade tensions are hurting both economies, but some degree of policy response in both countries – even if less than the market expects – looks set to mitigate any weakness.

For technical reasons related to quantitative easing, the inversion of the US yield curve could well be overstating risks the economy falls into recession during the next year or two.

Meanwhile, other economies are benefiting from the China-US spat. Vietnam, Taiwan and South Korea have picked up a significant amount of China's lost business and Chinese firms have increasingly switched to Latin America from the US for their agricultural imports.

Notably, the euro zone's outlook has been improving – and that's even before European Central Bank President Mario Draghi's delivers on a renewed commitment to provide stimulus as and when needed.

FIG. 1 BOND YIELDS UNDERSTATING INFLATIONARY PRESSURES
Global inflation versus bond yields, %



Source: Refinitiv. Data covering period 15.06.1999 to 26.06.2019.

Our **liquidity** analysis offers a reason for optimism. Should the Fed meet the market's expectations on policy easing, other central banks may follow as they seek to keep their currencies from appreciating and thus hurting their trade competitiveness. That public sector boost would reinforce growing private sector liquidity provision, with credit edging higher across all major regions.

Valuations are flashing red for bonds. Euro zone and Swiss bonds are the most expensive they've ever been. Indeed, apart from US investment grade credit and emerging market local currency debt, which are only just in neutral valuation territory, every other asset in the fixed income universe is overvalued.

Elsewhere, despite their strong run during the month, global equities broadly look fairly priced. Still, with the earnings outlook looking considerably weaker than analysts have forecast – we see no growth in earnings over the coming 12 months against consensus expectations of about 7 per cent - stocks remain vulnerable.

Technicals offer support for bonds, which benefit from strong seasonal trends. And despite their big rally, they still don't look overbought, according to the investor positioning indicators we monitor. As for equities, the trend is neutral and seasonality is negative, but they remains a curiously unloved investments. This relatively light positioning in equities among investors suggests any selloff in shares is likely to be limited. Meanwhile, gold, the strongest performing asset during the month, should continue to be supported by strong seasonality, while it too isn't yet overbought.

Equity sectors and regions: Europe's summer glow

It is prudent to keep a cautious stance on equities at a time when corporate profits are under threat from a slowdown in world trade.

Our model now indicates that global corporate earnings will be flat to lower in the coming year, compared with a 12-month consensus forecast for a 7 per cent growth.

US equities are particularly vulnerable. Not only are they the most expensive stocks on our scorecard but our leading indicators show the US economy has been slowing for six months in a row, underperforming major developed and emerging countries. Historical evidence suggests that US corporate profits tend to fall when the economy grows by less than 3 per cent on a nominal basis.

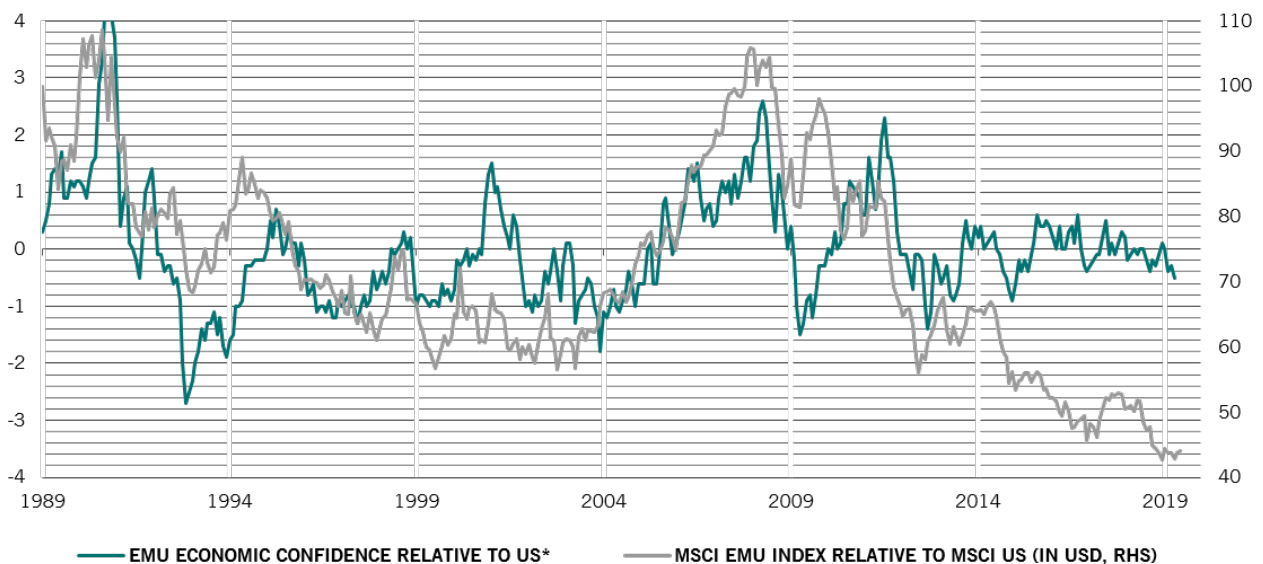
Wall street is unlikely to receive a fresh boost from possible Fed interest rate cuts as the market has already discounted aggressive monetary easing in the second half of 2019.

What is more, mainstream US equity indices such as the S&P 500 index have a heavy weighting in technology companies, a sector that is susceptible to tighter regulation and damage from the trade war.

In contrast, prospects for European stocks are brightening. The region's leading indicator, while still in negative territory, has been improving for three months, outperforming the US. Consumption, which is the main engine of growth in the area, remains resilient and bank lending is improving. European stocks are cheaper than the US on a relative basis, according to our valuation model, which takes into account price to book, price to earnings and price to sales ratios.

DUE A CATCH UP

European stocks should narrow performance gap with the US



UK stocks remain attractive. The market offers a high dividend yield of 4.8 per cent while a weak sterling, due to Brexit-related worries, is boosting profits for many British multinational companies.

We also like emerging markets. Our leading indicators show emerging economies are outgrowing their developed peers, while EM earnings growth for 2020 is expected to exceed 14 per cent, above that of advanced markets.

We remain neutral on sectors that are vulnerable to any depreciation of the dollar, such as energy and materials. We also keep a neutral stance on economically sensitive industries such as financial and real estate.

Fixed income and currencies: when doves cry

From 50 basis points of hikes six months ago to 100 bps of cuts today. The shift in investors' expectations for US interest rates for the next 12 months – as priced in by bond futures contracts – has been breath-taking. It has also, we believe, been excessive.

CUTTING TOO DEEP
US Fed Funds Target Rate Expectation (June 2020)



Source: Refinitiv. Data covering period 01.06.2018 to 26.06.2019.

Markets are likely to be disappointed by the scale of cuts delivered, which in turn should push up bond yields and depress prices. After an excellent half year, global bonds are looking more expensive than ever, prompting us to reduce our allocation to negative from neutral.

Developed market credit – both investment grade and high yield – remains expensive. This is a red flag given that we expect corporate earnings to undershoot expectations. At the same time, credit ratings are deteriorating, while leverage is on the rise – non-financial US corporate debt is at an all-time high at over 47 per cent of GDP, higher than the levels seen in either 2000 or 2008.

When it comes to defensive assets, US Treasuries still offer much more attractive yields than their euro zone counterparts, supporting our overweight position on the former and underweight stance on the latter. Indeed, German Bunds are at their most expensive levels ever, with yields at a record low of -0.3 per cent, and 45 per cent of all euro zone government debt is now in negative yield territory.

Prospects for emerging market local currency debt are looking brighter thanks to falling inflation in the developing world, the likelihood of monetary easing and cheap exchange rates. According to our models, emerging market currencies are 15 to 20 per cent undervalued versus the dollar.

However, with the traditionally volatile summer period upon us, we have decided to take some risk off the table by trimming dollar-denominated emerging market debt to neutral from overweight. The asset class has performed very well and now looks relatively expensive according to our valuation models.

We also have an overweight position on gold. Although the precious metal has been the standout outperformer over the past month – up 6.4 per cent – it is still far from overbought. Both seasonality and trend indicators are also favourable.

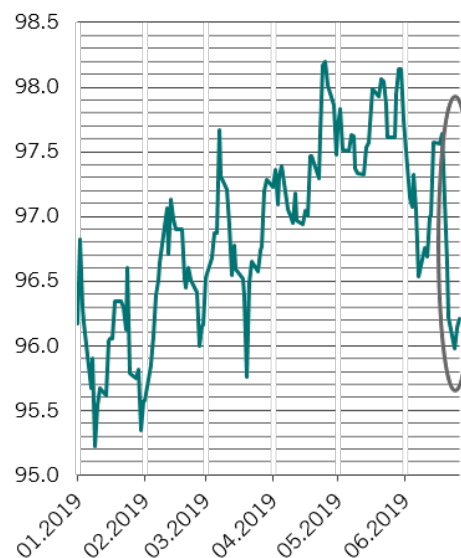
Global markets overview: rate cut hopes fuel equities

Equities outperformed bonds last month, gaining nearly 6 per cent as investors grew confident the Fed would cut interest rates as early as July. Growing optimism Washington and Beijing would soon resume trade negotiations also supported the market. The US equity market was the outperformer, with the MSCI US index delivering gains of some 7 per cent and the S&P 500 hitting all-time highs.

Within sectors, materials and IT benefited from renewed hopes for a US-China trade deal, advancing more than 8 per cent. Companies that are most sensitive to economic cycles – such as energy and IT – outperformed defensive sectors, such as utilities. Cyclical stocks are now trading at a 16 per cent premium on a cycle-adjusted basis to their defensive counterparts, above the long-term average of 10 per cent.

The dollar fell more than 1 per cent in the month as investors priced in the prospect of easier monetary policy in the US (see chart). This, in turn, supported many emerging market assets, such as export-sensitive Asian equities and EM local debt, both of which rose over 5 per cent.

DOLLAR DEPRESSION
Dollar versus trade-weighted currency basket



Source: Refinitiv. Data covering period 01.01.2019-26.06.2019.

In fixed income, gains in developed corporate bond markets outpaced those of sovereign debt, with US and European high yield debt advancing more than 2 per cent.

Gold was the best performing asset class as a combination of a weaker dollar and safe-haven seeking investor flows pushed the precious metal up by more than 8 per cent.

Oil jumped about 6 per cent as attacks on two oil tankers in the Gulf of Oman, which prompted the US to impose fresh sanctions on Iran, threatened to cause supply disruptions. Oil prices are likely to come under further upward pressure after Russia and Saudi Arabia agreed a deal to extend their limits on oil output, which keep about 1.2 million barrels a day off the global market.

BAROMETER JULY 2019

Asset allocation

A sharp fall in yields prompts us to cut bonds to underweight.

Equity regions and sectors

Remain underweight the US; we like European, UK and EM stocks.

Fixed income and currencies

Within the fixed income space, we prefer US Treasuries and emerging market local currency sovereign debt.

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