PICTET
1805

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE (Maximum change ◀◀◀◀ ▷▷▷▷)
GLOBAL ASSET CLASSES We stick to our overweight stance on equities as growth is gathering strength across the developed world, feeding through to corporate earnings.				Equities		
			Bonds			
		Cash				
				Gold		
			Oil			
			USD			
EQUITY REGIONS AND STYLES Japan and Europe remain our favoured stock markets; both regions benefit from monetary stimulus and improving economic growth.				Japan		
	US					
				Europe		
			Pacific			
			Emerging			
				Mid & Small Cap		▷
			Value			
EQUITY SECTORS Our cyclical tilt has been reinforced with the upgrade of both industrials and information technology to overweight.			Energy			◀
			Materials			
				Industrials		▷
				Consumer Disc		
		Consumer Staples				◀
		Healthcare				
				Financials		
				IT		▷
		Telecoms				
		Utilities				
FIXED INCOME With many government bonds now offering negative yields, the risk-return profile of high-yield debt has improved; we therefore retain our overweight stance.		EUR Government				
		EUR Investment Grade				
				EUR High Yield		
				EMD Hard (USD)		
			EMD Local			
			EM Corporate			

Equities well supported by improving economic outlook

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

April 2015

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 30 March 2015

Global market overview

Equities slip after rally

Equities slipped in March, taking a step back from a rally fuelled by monetary stimulus from the world's central banks. Losses were led by energy and material sectors and Latin American markets. Bonds ended the month in negative territory but outperformed equities.

Japan was the best performing equity market, with the benchmark index approaching a 15-year peak as expectations grew that the world's third biggest economy would improve steadily and shareholder returns would increase gradually.

Led by a rally in German stocks, European equities also fared better than the global index amid optimism that the European Central Bank's asset-buying plan can revive growth and that the recent EUR decline will support corporate earnings.

Emerging market stocks saw sharp falls, led by Latin American markets.

In the currency markets, the USD rose against major currencies to hit a 12-year high on a trade-weighted basis. Its 21 per cent trade-weighted gain over the past nine months amounts to its strongest appreciation ever. Nevertheless, the rate of increase has slowed in recent weeks (see chart). This is because the Fed cut its forecast for US inflation and economic growth and took a less aggressive stance on when it might raise interest rates, prompting many investors to push back the timing of the first US rate hike.

In fixed income, the change in the Fed's economic assessment supported US Treasuries, which was the best performing government debt market in March.

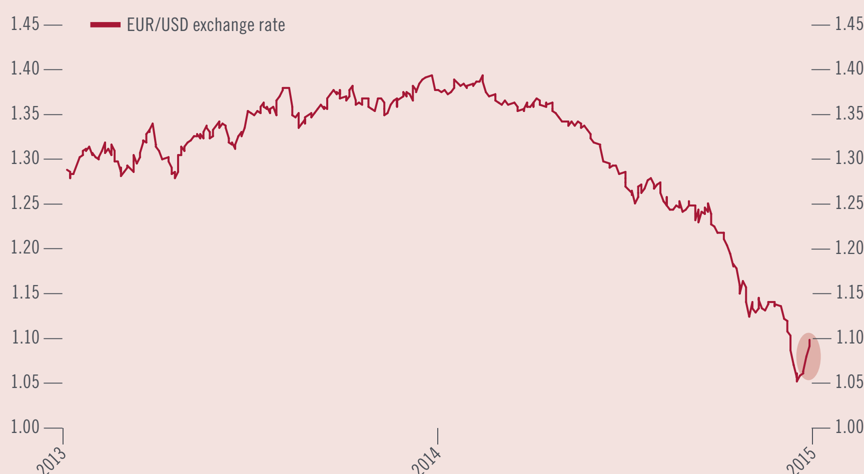
The two-year Treasury yield posted its biggest daily drop since May 2010 after the March FOMC meeting.

Continued strength in the USD weighed on emerging market bonds.

Brazil was the biggest loser, with its currency and local bonds down more than 10 per cent in March as concerns about a recession, a credit rating downgrade and the fallout from a corruption scandal at state-run oil firm Petrobras triggered investor outflows.

Brent crude prices fell some 10 per cent as concerns grew about the rising level of stockpiles around the world.

USD APPRECIATION BEGINS TO LOSE STEAM



Source: Thomson Reuters Datastream

Asset allocation

Equities in favour; remaining neutral on bonds, USD

We are keeping our overweight stance in equities as monetary stimulus from the world's central banks should support riskier asset classes and underpin growth in both developed and emerging economies.

Also encouraging is the fact that corporate earnings are improving. As the chart overleaf shows, the proportion of companies raising earnings estimates relative to those cutting forecasts is rising sharply.

We retain our neutral stance on bonds as yields are likely to remain range-bound in the absence of inflationary pressures; the USD is also kept at neutral as the pace of its appreciation has slowed in recent weeks.

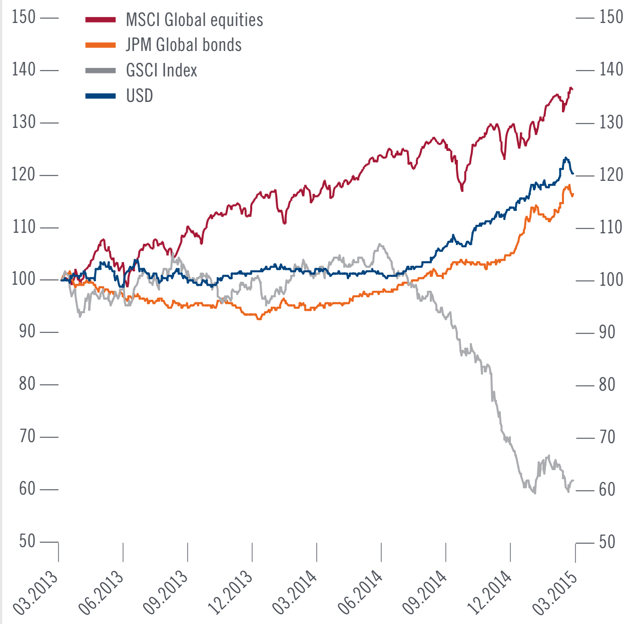
Our **business cycle** readings remain positive at a global level, with world leading indicators moving decidedly above their long-term average. Europe and Japan are well placed to lead the global recovery, in contrast to the US, where recent data has been disappointing on the whole.

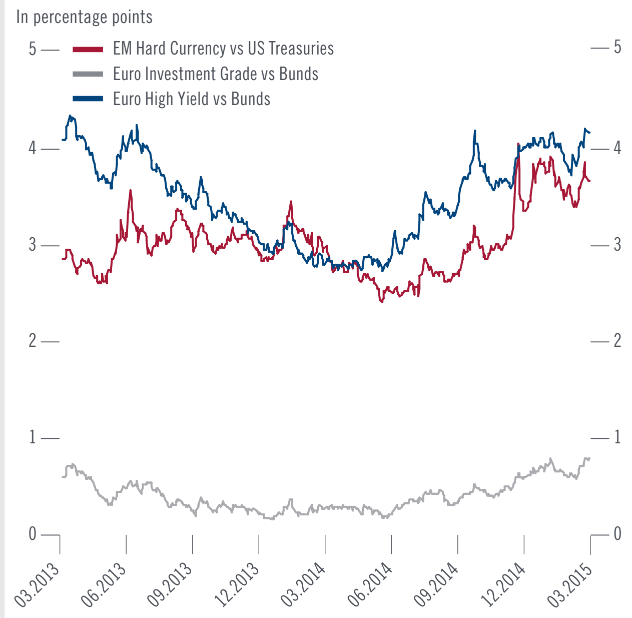
In the US, both manufacturing and retail sectors have continued to lose momentum. Manufacturing surveys have declined for four months in a row while business investment has deteriorated further, pointing to weaker industrial activity. Despite a decline in oil prices, US households have preferred to hold on to what they have saved from lower energy costs rather than increase spending on consumer goods. This has weighed on retail sales. At the same time, the strong USD has proven to be a mild drag on exports – our calculations show a 10 per cent decline in the trade-weighted USD reduces the country's exports by about 6 per cent.

However, we think the current economic weakness will be short-lived. Growth will probably rebound to about

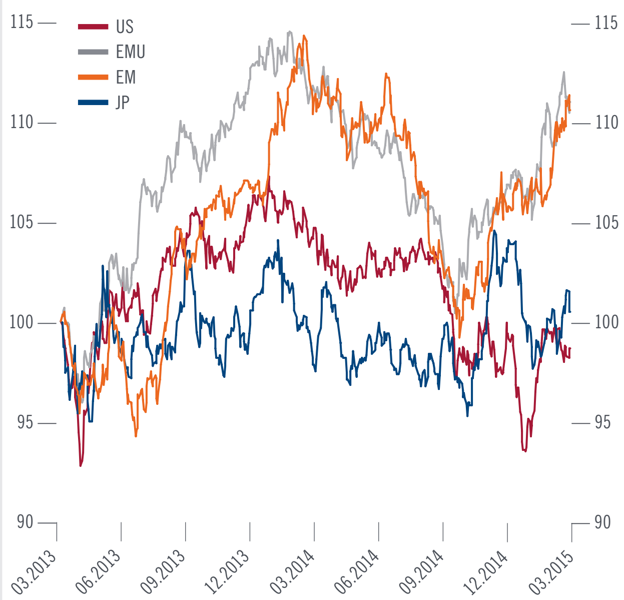
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

MAJOR ASSET CLASSES





EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE



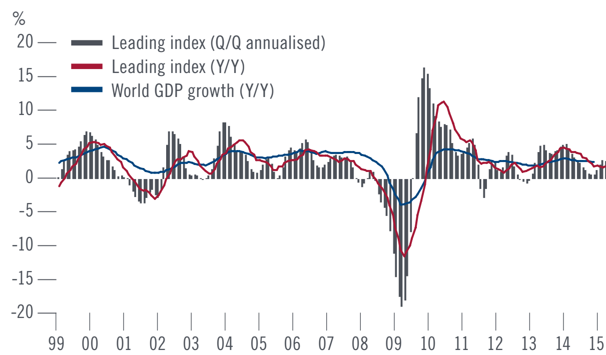
Source: Pictet Asset Management, Thomson Reuters Datastream

RISK BIAS INDICATORS

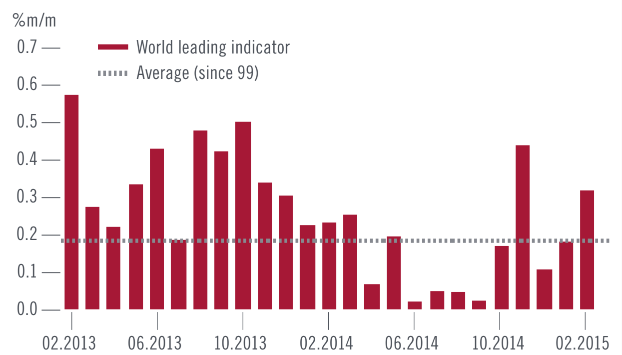
MONTHLY CHANGE Maximum change ◀◀◀◀ ▷▷▷▷	RISK-OFF –	NEUTRAL ○	RISK-ON +
		Business cycle	Business cycle
		Liquidity	Liquidity
	Valuation	Valuation	
▷		Sentiment	
		PAM strategy	PAM strategy

BUSINESS CYCLE: WORLD ECONOMIC GROWTH CONTINUES TO BUILD

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

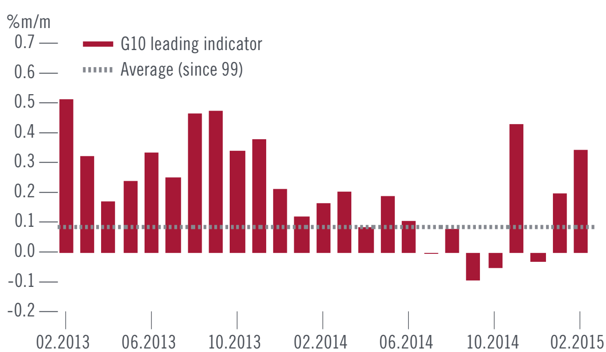


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

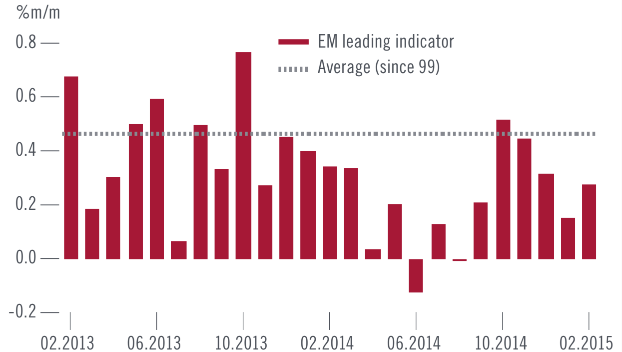


ECONOMIC MOMENTUM IN G10 PICKS UP FURTHER; EMERGING MARKETS LAG

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



Source: Pictet Asset Management, Thomson Reuters Datastream

VALUATION: EQUITY MARKETS AND SECTORS

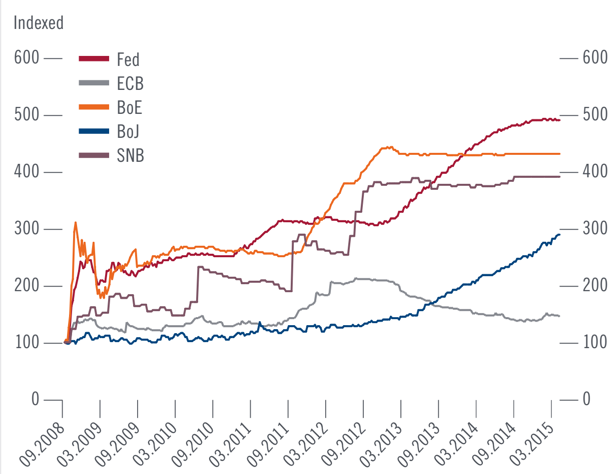
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH 2015	EPS GROWTH 2016	SALES GROWTH 2015	SALES GROWTH 2016	PE 2015	PE 12M	PB 2015E	P/SALES 2015E	DY 2015E
US	1%	13%	-1%	6%	17.6	17.0	2.6	1.8	2.1%
Europe	3%	13%	-1%	5%	17.3	16.7	1.9	1.3	3.2%
EMU	15%	14%	2%	5%	16.8	16.2	1.7	1.1	3.0%
Switzerland	-5%	9%	0%	4%	18.4	18.0	2.6	2.4	3.1%
UK	-9%	14%	-7%	7%	16.1	15.6	1.8	1.2	3.9%
Japan	15%	9%	3%	3%	17.7	15.4	1.5	0.8	1.8%
EM	9%	12%	2%	8%	12.3	11.9	1.5	0.8	2.8%
NJA	11%	10%	3%	8%	12.5	12.2	1.5	0.7	2.7%
Global	**3%**	**13%**	**0%**	**6%**	**16.9**	**16.4**	**2.1**	**1.4**	**2.4%**

MSCI GLOBAL SECTORS	EPS GROWTH 2015	EPS GROWTH 2016	SALES GROWTH 2015	SALES GROWTH 2016	PE 2015	PE 12M	PB 2015E	P/SALES 2015E	DY 2015E
Energy	-45%	37%	-21%	13%	21.4	19.6	1.3	0.8	3.5%
Materials	1%	17%	-1%	5%	16.7	16.0	1.8	1.0	2.7%
Industrials	12%	10%	3%	4%	16.9	16.5	2.3	1.0	2.2%
Consumer Discretionary	16%	14%	6%	6%	18.0	17.4	2.9	1.2	1.8%
Consumer Staples	2%	10%	4%	5%	21.2	20.6	3.9	1.3	2.6%
Health care	7%	13%	6%	6%	20.3	19.6	3.9	2.3	1.7%
Financials	11%	11%	5%	6%	13.3	13.0	1.3	1.8	3.0%
IT	9%	11%	7%	5%	16.8	16.1	3.2	2.2	1.6%
Telecoms	8%	9%	3%	3%	16.8	16.6	2.3	1.4	3.9%
Utilities	7%	-1%	0%	2%	15.2	15.2	1.5	1.0	3.7%

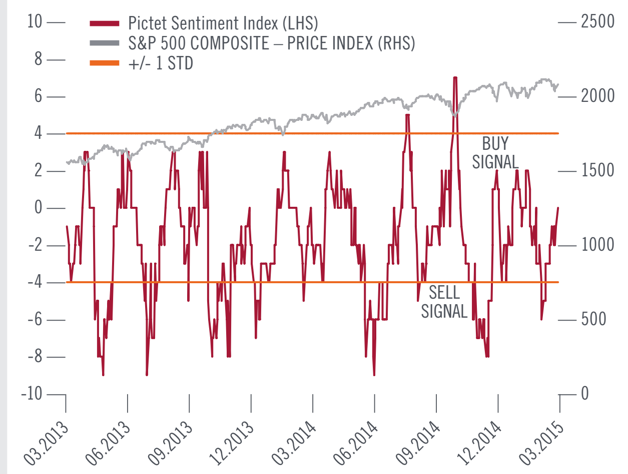
LIQUIDITY: FED ENDS QE BUT MONETARY STIMULUS CONTINUES ELSEWHERE

SIZE OF CENTRAL BANKS' BALANCE SHEETS



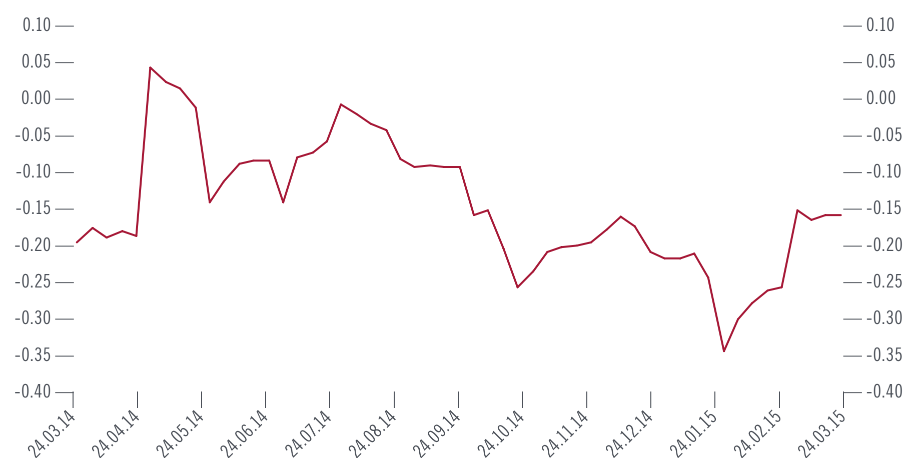
SENTIMENT INDICATOR SHIFTS TO NEUTRAL

PICTET SENTIMENT CYCLE INDEX



CORPORATE EARNINGS FORECAST UPGRADES ON THE RISE

Net percentage of companies raising profit forecasts*



*Calculation: no. of companies raising estimates – no. of companies cutting estimates/total number of companies x 100

Source: Thomson Reuters Datastream, Pictet Asset Management, MSCI AC World constituents (12-month EPS)

3 per cent (annualised) in the second half of this year, significantly above the long-term trend. We also expect wage growth to pick up to 2.5 per cent in the third quarter, allowing the Fed to begin raising interest rates later in the year.

Elsewhere, the euro zone economy continues to show signs of improvement. Leading indicators have accelerated further, led by increased retail spending, especially in Germany. Consumer confidence in the single currency bloc has hit its highest level since September 2007, while credit growth remains strong, particularly among households. The ECB's EUR60 billion a month asset purchase programme should help lift credit growth further, in our view. What is more, the recent decline in the EUR should help lift exports, providing a boost to corporate earnings.

Meanwhile, Japan's economy is making a steady recovery after falling into recession last year. Leading indicators have risen for the second month in a row while industrial output has recovered thanks to the fillip exports have received from a cheap JPY. With inflation easing further, the Bank of Japan may increase the size of its monetary stimulus programme to push prices up and thereby maintain its credibility.

China's economic activity is slowing, hampered by industrial, construction and property sectors. We think the economy is likely to pick up in the coming months on the back of strong export performance – nominal exports have risen 20 per cent on a six-month annualised basis – and resilient domestic demand, which should be further supported by the People's Bank of China's monetary stimulus. The government's move to ease pressure on indebted local governments with a bond swap programme is another positive signal.

Elsewhere in emerging markets, economic performance continues to diverge between energy consumers such as India, which benefit from lower energy costs, and commodity exporters. Brazil is a major weak spot, with fiscal tightening and higher interest rates weighing on the domestic economy.

Looking ahead, we expect a recovery in external demand to help boost emerging market export growth – especially as emerging currencies remain deeply undervalued, or some 26 per cent below their long-term fair value according to our model.

Liquidity conditions are favourable at a global level. Our European readings hit their highest level on record, buoyed by the ECB's easing programme. Liquidity conditions also improved in the US as credit growth has picked up; they may deteriorate later this year, however, when the Fed raises interest rates. There are encouraging signs from emerging markets, where a number of central banks cut interest rates. Signals are especially positive in Asia.

Sentiment indicators have shifted to a neutral level globally as investor positioning in US stocks has become less bullish. Europe sentiment indicators fell to negative, however, after a broad rally in the region's equities and a marked pick-up in portfolio flows into the region.

Valuations are less supportive for stocks. Major equity indices are near record highs, with earnings multiples above their 2007 peaks. Globally, equities trade at a 12-month forward P/E of 16.4. However, equities still look attractive relative to bonds, with the implied equity risk premium[1] well above the long-term average in all major markets.

[1] The implied equity risk premium is a measure of the extra return investors can expect to receive over bonds as compensation for taking on extra risk. Our ERP model incorporates corporate earnings estimates and trend GDP growth.

Equity region and sector allocation

Europe and Japan remain our favoured markets; raising industrials

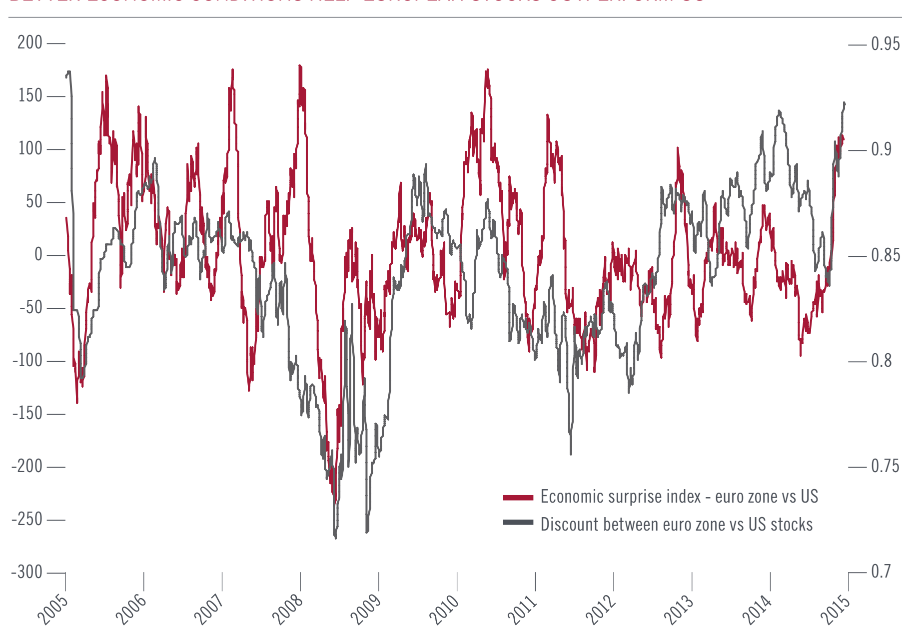
Our regional allocation remains unchanged, with overweight positions in European and Japanese equities. Even though European stocks have outpaced their US counterparts in recent months, there is scope for this trend to gain further momentum over the near term.

The improving macroeconomic backdrop in the single currency region is a major plus. German retail sales adjusted for inflation rose 5 per cent on the year, the highest level in 20 years. The recent wage settlement for metal workers also points to a strong increase in purchasing power for consumers. Moreover, the fall in the value of the EUR is serving to boost the competitiveness of companies in Southern Europe, particularly exporters based in Spain and Italy, while lending to non-financial corporates has risen.

The economic surprise index for the euro zone – which tracks the extent to which data releases surpass or undershoot expectations – is at its most positive level for two years. And this is before the effects of the ECB's quantitative easing are taken into account. Healthier business conditions are beginning to filter through to corporate earnings: profit forecast revisions across Europe are improving at a rapid pace. The net proportion of companies raising profit estimates relative to those cutting them has improved to -7 per cent from -18 seen at the end of last year.

The situation in Europe compares favourably with the conditions we see in the US, where the strong USD is beginning to crimp the earnings of exporters and stocks look expensive on a range of valuation metrics. At just below 28, the cyclically-adjusted price-earnings ratio for the S&P 500 index is at the same level it was in 1999, before the bursting of the tech bubble. Taking all this into account, we expect the discount at which European stocks trade to US equities to narrow further – it is currently at around 10 per cent on a price-earnings basis (see chart).

BETTER ECONOMIC CONDITIONS HELP EUROPEAN STOCKS OUTPERFORM US



Source: Thomson Reuters Datastream

Japanese stocks also retain their appeal, in our view. Economic reforms, persistently loose monetary policy, and a weak JPY should continue to boost earnings momentum across corporate Japan. What is more, we are seeing increased evidence of an improvement in corporate governance across the country, which should result in more shareholder-friendly policies such as dividend increases, share buybacks and growth-boosting acquisitions.

Our style and sector positioning has changed to reflect our increased optimism in global growth prospects. We raise small and mid-cap stocks to overweight and also increase our exposure to industrials to overweight – the sector is an inexpensive way to tap into the pick-up we expect to see in economic activity.

Our cyclical tilt is reinforced with an upgrade to technology stocks to overweight. This is a sector with strong fundamentals and reasonable valuations.

Consumer staples stocks are cut to underweight, largely on valuation grounds. We have reduced energy to neutral as oil prices appear set to trade within a range. After the fall in their earnings per share, energy stocks no longer look cheap. While materials is the cheapest sector on our scorecard, we are inclined to remain neutral on the sector until we see evidence of a revival in Chinese economic conditions.

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Fixed Income

High yield attractive in a world of negative yields

As negative yields become more widespread across the European fixed income market in the wake of quantitative easing from the ECB, the risk-reward profile of government bonds is deteriorating. At one point in March, some USD1.5 trillion of the bonds in JP Morgan's global bond index and almost one in four of the securities in its Euro credit index were offering negative yields. The rally in euro zone government bonds has also pushed the yield spread between 10-year German Bunds and US Treasuries to its widest level since the birth of the euro, or some 160 basis points (see chart).

Against this backdrop, we retain our positive stance on high-yield bonds. With economic conditions in the euro zone set to improve further in the months ahead and the Fed likely to deliver just one interest rate hike this year, the yield pick-up offered by sub-investment grade debt is attractive. Non-investment grade bond spreads offer more than sufficient compensation against the risk of default, which should decline as economic growth picks up and credit conditions remain benign. The technical picture is also positive. Although high yield issuers continue to tap the bond market, the payments investors are receiving from bond redemptions and coupons are flowing back into the asset class.

Elsewhere, we continue to hold a neutral position on emerging corporate bonds. While a strong USD and higher US interest rates could make it more costly for such companies to service their debts, we do not believe the asset class is about to see a spike in defaults or an across-the-board deterioration in creditworthiness. Weak domestic currencies do not automatically mean corporate finances become more precarious. Several companies in the emerging world actually benefit from a rising USD. Asian-based firms, who make up a large portion of the emerging bond market, look especially well placed as a large proportion of their earnings are denominated in USD. What is more, companies operating in mining, sugar, beef, pulp and paper generate revenues in USD but have a cost base which is largely in local currency. For these firms, a rising USD means higher profit margins. That said, we are not inclined to lift our exposure to the asset class – or local currency emerging bonds – until we see more evidence of a recovery in emerging market economic growth.

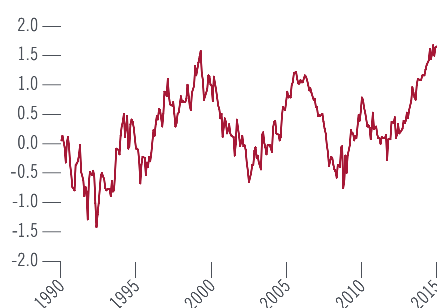
In government bonds, we continue to favour long-dated Italian and Spanish debt. The yield differential between such securities and German government bonds in the very long end of the curve is, in our view, too wide given that one of the aims of QE is to keep a lid on borrowing costs in Southern Europe.

Olivier Ginguené, Chairman
Pictet Asset Management Strategy Unit

Luca Paolini, Chief strategist
Pictet Asset Management

US-GERMANY BOND YIELD GAP WIDENS IN WAKE OF ECB QE

Yield differential, basis points, 10-year Treasuries vs Bunds



Source: Bloomberg

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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