PICTET
Asset Management

ASSET ALLOCATION

Upbeat growth, simmering risks

January 2017

Pictet Asset Management Strategy Unit

We upgrade equities as stronger global growth boosts the prospects for risky assets. We also raise bonds, which offer reasonably priced insurance against market volatility.

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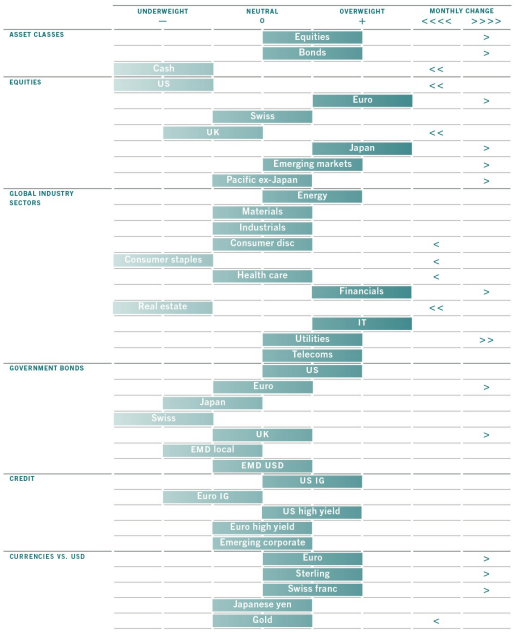
Market overview: stocks fired up by Trump

In January, financial markets accentuated the positives of President Donald Trumps' proposals to fire up the US economy with fiscal stimulus. Investors bought equities, cut exposure to government bonds and sold the US dollar. At the same time, they ignored the risks Trump's administration might pose to world trade and instead focused on the prospects of a return to synchronised global growth.

MONTHLY ASSET ALLOCATION GRID
February 2017



Source: Pictet Asset Management

Emerging market (EM) stocks saw the strongest gains, ending the month higher by some 6 per cent in US dollar terms; Latin American markets were the best performing by some distance.[1] In the US, both the S and P 500 and the Dow Jones Industrial Average indices hit record highs as investors were enthused by Trump's plans to boost infrastructure spending and cut corporate tax rates. According to the OECD, the proposed US fiscal package could amount to the biggest spending splurge outside recession, adding some 1.2 percentage points to US growth in 2018. Euro zone stocks also ended higher as the region's economic growth remained buoyant and the European Central Bank sounded a dovish note.

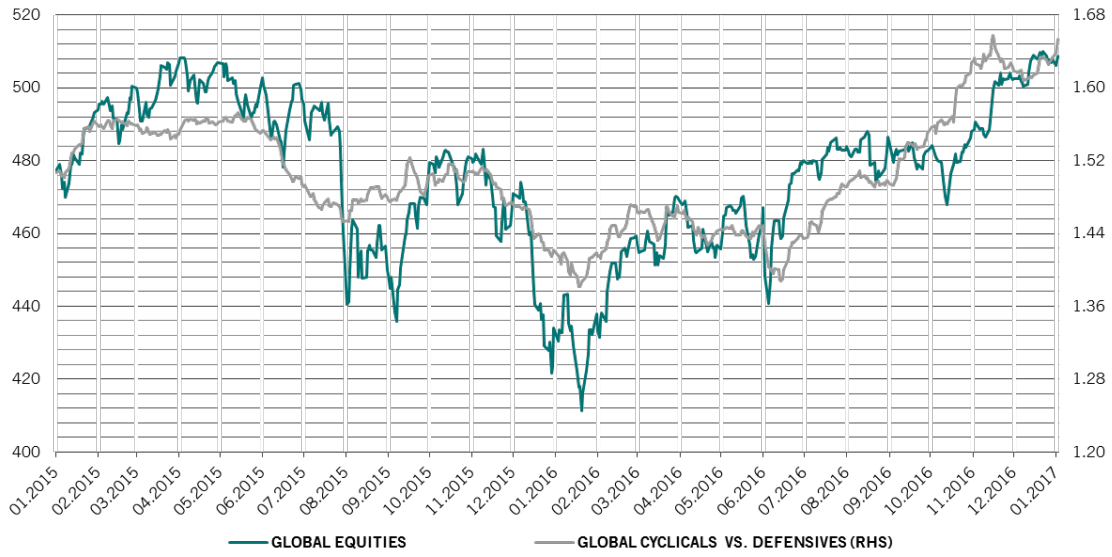
Amid the rally, cyclical and financial stocks outpaced defensive shares on the whole, reinforcing a trend that has been in place for some months (see chart). Materials and information technology stocks were the best-performing sectors in global indices while utilities and energy suffered.

In pricing in the prospect of a pick-up in the pace of global growth, investors scaled back their holdings of government bonds. Euro zone, Japanese, Swiss and

UK government bonds ended the month in negative territory. US government debt was flat. Emerging market local currency and US dollar debt were bright spots, however, both ending up on the month by more than 1 per cent.

The prospect of a further rise in interest rates lay behind a spike in bond issuance among sovereign and corporate borrowers worldwide. Keen to lock in cheap borrowing costs before the Fed tightens monetary policy later this year, companies and government agencies issued over USD600 billion of new debt in January, almost a fifth more than they sold in the same month last year.

CYCLICAL STOCKS DRIVE EQUITY RALLY*



*MSCI World All Country Equity Index; Global vs. cyclical stocks return expressed as a ratio; Source: Thomson Reuters Datastream

In the currency markets, the US dollar fell against many G-10 and EM currencies after Trump suggested his administration may not adhere to the 'strong dollar' policy the country has hitherto pursued. At the same time, investors found themselves overexposed to the dollar following the currency's strong rally in the autumn. The euro, Japanese yen, Australian dollar, Brazilian real and Russian rouble each saw gains of more than 1 per cent against the greenback.

[1] Returns data as of 30.01.2017

02

Asset allocation: raising equities, fixed income hedges added

The inauguration of the new US president has further buoyed financial markets

The inauguration of the new US president has further buoyed financial markets, with investors expecting Trump's pro-growth policies to boost the global economy. Economic activity had in any case been gaining momentum across all regions, lifting equities, and brightening corporations' earnings prospects.

At the same time, central banks in Europe, Japan and parts of the emerging world are supporting their economies with monetary stimulus.

This adds up to a benign investment climate. As a result we are upgrading our equity exposure to overweight from neutral and cutting cash to underweight from neutral.

In a tactical move we have also raised our exposure to fixed income. Government bonds have sold off too sharply in our view, having suffered a 6 per cent decline since July, the sharpest six-month loss in a decade. Investor positioning in the asset class is now excessively bearish, as demonstrated by CFTC data, suggesting the next move in yields could be down. What's more, in the wake of their sell-off, bonds provide insurance against market volatility – in the form of, say, unexpected policy shifts from Trump – at a reasonable, if not cheap, price.

Our **business cycle** indicators paint an upbeat picture of the global economy. The world purchasing managers index (PMI) hit a three-year peak and our leading indicators are at their highest levels in at least two years. Private investment also appears to be accelerating. In the US, which is one of the best-performing developed economies, manufacturing, consumption and labour market data point to buoyant economic conditions. In the absence of strong inflationary pressures, we expect the US Federal Reserve to raise interest rates only twice in 2017.

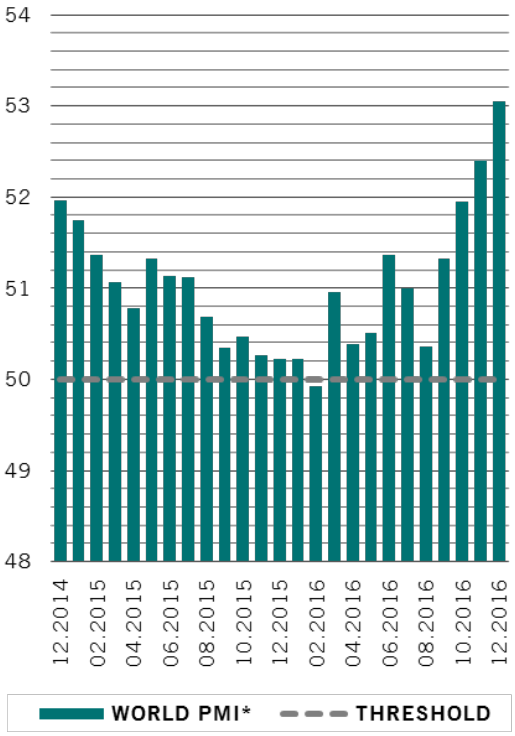
The euro zone's recovery is on track thanks to buoyant consumer spending in Germany and as a weaker currency supports exports. We expect conditions to have improved enough over the next several months to allow the ECB to further scale back quantitative easing in the early part of 2018. Japan is also enjoying positive momentum with the Bank of Japan's monetary stimulus facilitating a broad-based recovery in industrial and consumer sectors, both of which have been aided by a weaker yen.

In China, economic growth is likely to remain stable around the current annualised rate of 6.8 per cent, supported by consumption and investment. However, risks are lurking – there is the potential for trade disputes between China and the US. Trump has threatened to declare Beijing a currency manipulator and levy a 45 per cent punitive tax on all Chinese goods.

China's capital outflows have also been a concern as attempts by authorities to keep the currency stable pushed the country's foreign reserves down towards USD3 trillion in November, the lowest in nearly six years. In the short term, however, outflows have stabilised after regulators tightened rules on overseas currency transfers.

Our **liquidity** analysis suggests riskier assets should

STRONG GLOBAL PMI POINTS TO GDP GROWTH



*Manufacturing PMIs of 26 countries, GDP-weighted; Source: Pictet Asset Management, JP Morgan Markit

Our **liquidity** analysis suggests riskier assets should be treated with some caution. We expect the monetary support provided by the world's five major central banks to decline to USD800 billion this year from USD1.7 trillion in 2016. That said, there are some encouraging developments – the Chinese yuan's decline of 6 per cent on a trade-weighted basis since the start of 2016 had an equivalent effect of 100 basis points of rate cuts.

Our **valuation** readings show equities remain expensive after a broad-based rally following the US election. US equities, in particular, are close to their most expensive levels ever against their European and Japanese counterparts after the Trump euphoria lifted US benchmark indices to record highs. US stocks are trading at a cyclically-adjusted price-earnings ratio of 29 – some distance above the historical mean of about 17. The ratio of the S and P 500's market cap to GDP – Warren Buffet's preferred valuation gauge – is at levels last seen in the 1990s.

However, our analysis shows the US market is not in the bubble territory yet. [2] This is partly because we believe US corporate earnings growth can accelerate from the current forecast of 12 per cent, assuming that the US economy grows 2 per cent and the dollar stabilises.

Our **technical** signals have improved in the month to show a positive score for almost all regional equity markets. Market breadth – the proportion of equity sectors participating in the rally – remains high and history suggests stocks perform well in the early part of the calendar year. The signals for US equities are, however, less positive than they are for other markets. With the price of options that insure against market declines having fallen sharply, a correction cannot be ruled out.

[2] Pictet Asset Management US Equity Bubble Index is based on the following nine indicators: credit gap (bank lending/GDP), US equity price to book, AAII allocation to equities vs bonds, implied volatility, net inflows into equity funds, net margin debt % GDP, merger and acquisition volume % GDP, consumer confidence and household financial assets as % GDP.

03

Equity region and sector allocation: raising EM

What goes up must come down. US equities have had a stellar run, with the S and P 500 and the Dow Jones both hitting record highs in January. The market's fundamentals look pretty strong: the US economy is performing well and the Trump administration has begun implementing growth-friendly policies.

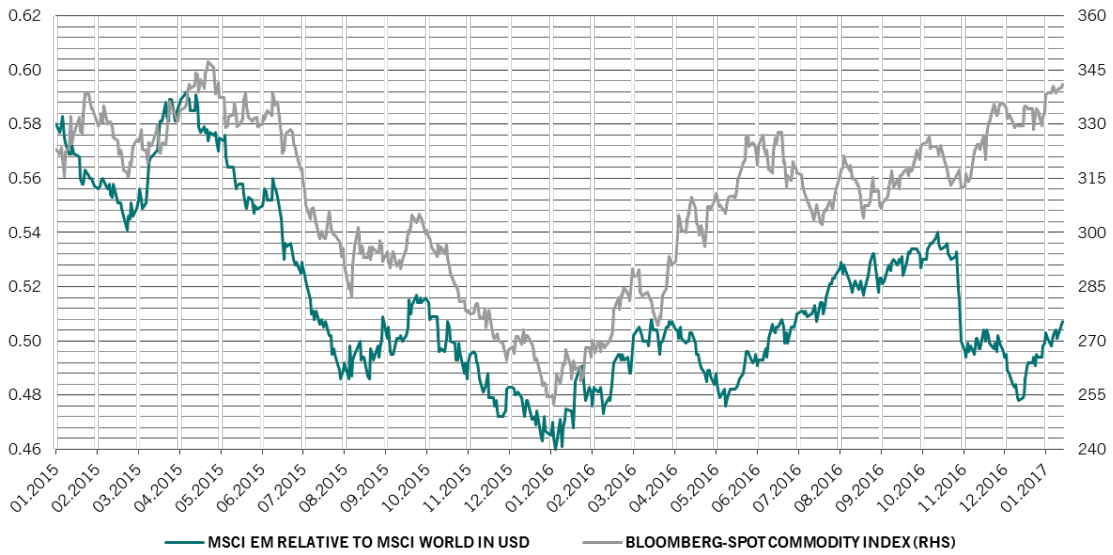
That said, much of the good news has now been factored into stock prices. We now see limited scope for continued outperformance of the equity market: not only are US stocks expensive but they are also exposed to the unpredictable shifts in US policymaking.

That is why we are scaling back our exposure to the US, the most expensive of all the major global regional stocks markets, according to our models. Technical indicators indicating excessively bullish investor positioning in US stocks reinforce our view.

In contrast, some of the best value is on offer in emerging markets, particularly in Asia and Europe. Based on emerging market stocks' historical correlation with commodity prices (see chart), we see scope for developing world equity markets to outperform developed ones by 15-20 per cent over the medium term. The recovery in global exports should provide an additional boost, as will monetary easing in a number of countries including Russia, Brazil and India. We therefore upgrade EM equities to overweight.

We have also increased our exposure to both Japan and Europe. Despite its economic recovery, Europe remains largely unloved by most investors, probably because of the political upheaval that could result from the many general elections due to take place this year. But a cheaper euro and the growing prospect of a recovery in bank lending suggest corporate earnings in the region could gain strength.

SCOPE FOR EM STOCKS TO SHINE AS COMMODITIES RISE*



*Relative return of MSCI World to MSCI EM indices expressed as ratio; Source: Thomson Reuters Datastream, Bloomberg

Japan, meanwhile, boasts some of the best macroeconomic prospects in our investment universe. Indicators such as purchasing manager indices point to a continued recovery in industrial production, household disposable incomes are growing steadily and there is positive feed through from growth among other Asian countries. Car sales, industrial orders and bank lending are all heading higher, and we expect Japan's economy to grow 1.3 per cent this year, surpassing the consensus forecast of 1 per cent.

Cementing the investment case is the fact that the Japanese equity market is still cheap relative to its 20-year history – an anomaly given that cyclical sectors are a prominent feature of the country's stock indices. The BoJ's equity purchase programme should give the market an additional shot in the arm.

Among the global sectors, industrials and consumer discretionary stocks have both moved deeper into 'expensive' territory over the past month.

Given our positive readings on the global economy, we think the rally in cyclical stocks probably has a bit further to run, though – particularly in financials, a sector in which we have raised our exposure in the belief that Fed rate hikes will serve to boost bank lending margins. The technology sector is also attractive as such companies boast strong balance sheets and are well placed to benefit from any further pick up in global trade.

On the flip side, we slightly reduced exposure to consumer discretionary and real estate – whose prospects could deteriorate if rates head higher - and raised utilities to overweight. Among defensive sectors, we believe utilities is one of the best positioned to withstand the likely pick-up in inflation as such firms are better able to pass on price increases to customers.

Healthcare – although significantly cheaper than utilities – looks like a much riskier bet at the moment as the Trump administration prepares to replace the Obamacare legislation with an alternative that has yet to take shape; we have consequently cut our exposure to the sector.

04

Fixed income and currency allocation: dollar to soften

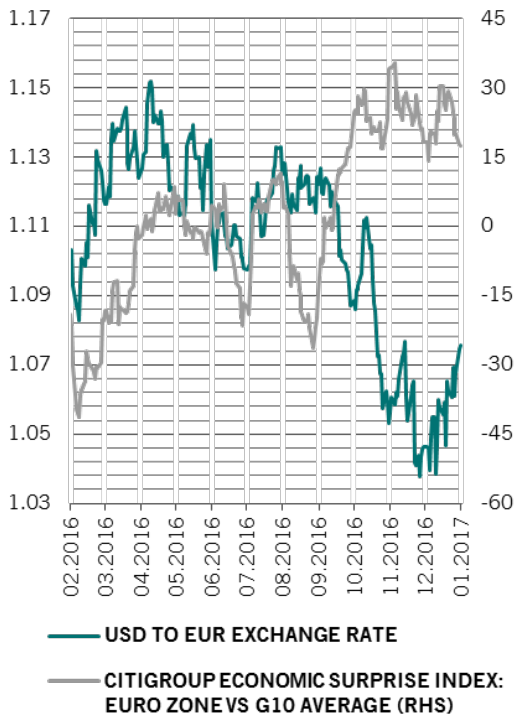
The heady dollar rally that began last autumn looks to be running out of steam. Having priced in all the possible good Trump-related news, investors seem to have started considering what might happen if the new US president's plans fall short or hit the buffers.

We think there could be more dollar depreciation to come and so have increased our European currency weightings, taking the euro, sterling and Swiss franc to

our European currency weightings, taking the euro, sterling and Swiss franc to overweight from neutral against the greenback. As the chart shows, the euro zone's economy has consistently surpassed expectations to a greater degree than its peers over recent several months. We believe this trend should continue, helping the single currency march higher. At the same time, we have also reduced our gold position to neutral from overweight as the prospect of higher US rates should reduce its appeal.

Separately, last autumn's heavy selloff in bonds offers a tactical entry point into parts of the market even if the asset class remains expensive on the whole. Although the global economy is gathering strength and inflation could be picking up, we believe long-dated US government bonds in particular may have over-reacted to these developments – the yield on the 30-year US Treasury bond has risen 77 basis points since the start of October. We therefore remain overweight US long-dated debt.

EURO SET TO GAIN GROUND AGAINST US DOLLAR*



*Proportion of data releases surpassing consensus forecast - euro zone relative to G10 economies; Source: Thomson Reuters Datastream

For one thing, Trump could find it harder to enact the parts of his policy agenda geared to stimulating growth – his tax reforms and infrastructure spending programme – than the parts that could slow it down, not least putting up trade barriers.

Elsewhere, we have also raised our exposure to UK bonds. The UK economy has been surprisingly resilient since last summer's Brexit referendum. Rather than driving the economy into recession, Brexit has supported growth by triggering a sterling devaluation.

But this this benign effect could begin to fade as markets once again start to worry about the costs of a "hard" departure from the EU with few if any trade concessions. This risk prompted us to raise UK gilts from underweight to neutral.

Otherwise, we remain underweight most non-US government bonds, apart from emerging market dollar debt, on which we are neutral.

Our corporate credit positions are also unchanged. We remain overweight US investment grade and high yield bonds, which should benefit from any increases in US fiscal spending as well as from protectionist measures. What's more, Moody's estimates that US high yield default rates peaked at 5.65 per cent in January 2017 after which they're expected to decline. We continue to underweight European investment grade credit.

In brief

FEBRUARY

2017

Global asset classes

Trump's pro-growth policies and accelerating global economic activity are likely to boost risky assets.

Equities

We cut exposure to US stocks after the rally; we find value in emerging market stocks, particularly in Asia and Europe.

Fixed income

The sell-off in bonds since late last year offers a tactical entry point into some government debt markets.