



MULTI
ASSET

MONTHLY ASSET ALLOCATION VIEWS

Barometer: Struggling for inspiration

October 2019

Pictet Asset Management Strategy Unit

European stocks are a bright spot in an otherwise uninspiring equity market.

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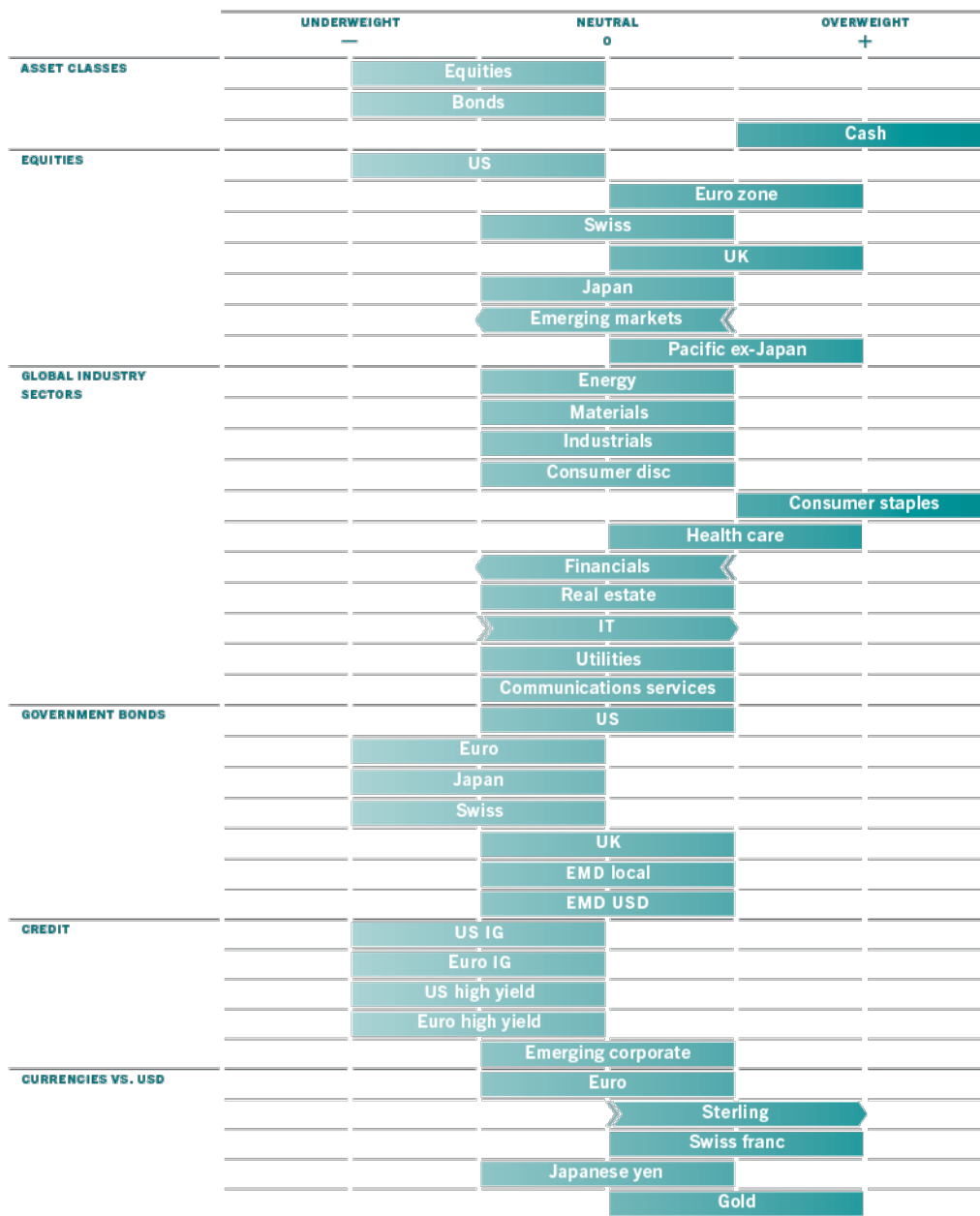
Asset allocation: looking to play it safe

Corporate profits are barely growing. Almost USD15 trillion of debt trades at yields below zero. And trade disputes are rumbling on. There is, then, not much for investors to be enthusiastic about. Not in the near term at least.

Our own global leading indicator suggests economic conditions will remain sluggish over the next few months. Our forecasts for world GDP growth have been falling since the summer; we now expect the global economy to expand at a sub-3 per cent pace compared to just above 3 per cent at the end of June. Such muted economic readings offset the positive signals that emerge from our assessment of liquidity and technical developments.

With this in mind, we remain underweight bonds and equities and overweight cash.

MONTHLY ASSET ALLOCATION GRID
October 2019



Source: Pictet Asset Management

Our **business cycle** readings don't give much to be optimistic about. Economic growth will slow a bit further before plateauing: our leading indicators suggest GDP will expand by around 2 per cent in early 2020, compared to the current rate of 2.7 per cent.

Trade is the economy's biggest problem. Although consumer demand is holding up, export orders are shrinking as a result of tariff hikes and other protectionist measures.

The impact is particularly visible in the two countries at the forefront of the dispute. In the US, weak manufacturing has pushed the ISM index to its lowest level in three years, and employment has also softened a little. In China, industrial production growth has slowed to a record low.

One bright spot is Europe. Our leading indicator for the euro zone has been positive for three months running, underpinned by healthy consumer spending.

Household demand is particularly strong. Even though retail sales edged down slightly consumer confidence is still very high and labour market conditions have improved. And lending to the private sector, a bug bear for the region, continues to gather speed.

Liquidity conditions are neutral to positive for riskier asset classes. The situation in Europe is encouraging, thanks to the European Central Bank's recent interest rate cut and restart of its asset purchase programme, under which it will buy EUR20 billion in securities per month. In China, however, the monetary policy taps have not opened by as much as many investors had hoped.

FIG. 1 YIELD PROBLEM
Negative yielding bonds, in USD bn



Source: Refinitiv. Data from 31.01.2014 to 25.09.2019.

Our **valuation** models show global equities are fairly priced. Yet this masks wide divergences among regions.

The US is one of the most expensive equity markets. With a cyclically-adjusted price-to-earnings ratio of 29 times, US stocks are poor value both in absolute terms and relative to peers. On a global basis, value stocks are attractive relative to growth stocks.

In fixed income, government debt and credit are at trading at some of the loftiest valuations seen over the past two decades.

One positive signal for equities comes in the form of **technical** indicators. As the year enters its final quarter, stocks should benefit from seasonal effects – the final three months of the year are generally kind to equity markets. Another plus is investors' unusually bearish positioning, which limits the scope for any sharp fall in stocks. At the moment, market positioning is very cautious, as evidenced by our analysis of net long positions in safe haven currencies (Swiss franc, Japanese yen and gold) versus those in a basket of traditionally riskier ones.

Equity sectors and regions: cutting back on emerging markets

Equity markets are undoubtedly getting a near-term boost from monetary stimulus. The ECB recently launched a series of easing measures, the US Federal Reserve is trimming rates and Chinese authorities are also loosening the monetary reins.

But we think the market latest gains represent nothing more than a bear market rally.

For one thing, the US expansion, already the longest on record, is beginning to show its age. Not only have warning indicators such as the US bond yield curve been flashing recession for some time, but corporate earnings are rising more slowly. At the same time, the trade war between the US and China continues to have a depressive effect.

Changes in market dynamics also give us cause to be cautious. After lagging their growth counterparts for years, value stocks rallied during September [see chart]. That growth stocks should lag is perhaps unsurprising given the recent uptick in bond yields – rising yields depress the present value of expected future earnings.

FIG. 2 GROWING VALUE
MSCI World Value vs Growth, rebased 23.09.2009=100



Source: Refinitiv. Data from 23.09.2009 to 25.09.2019; in US dollar terms

All of which leads us to take a more cautious view on equity regions and sectors.

Hence our decision to trim emerging market equities – which have had a good recent run – to neutral from overweight, to trim financials to neutral, also from overweight, and to lift technology to neutral from underweight.

There are, however, bright spots in the equity market. We maintain our overweight stance on the euro zone and the UK, largely on valuation grounds. Even if the downturn in world trade threatens to push the German economy into recession, this possibility has already been reflected by the country's stock market. The growing likelihood of fiscal stimulus – corporate tax cuts and infrastructure spending – makes it likely that once investor sentiment turns, it will do so robustly.

The backdrop is similar for the UK. Brexit has left UK equities as the cheapest of all the global stock markets, while sterling is also undervalued. With plenty of bad news priced in, any resolution to the country's political turmoil is likely to see a big snap-back. We figure there's the prospect of a 20 per cent upside to the market.

Fixed income and currencies: hard to find value in a sub-zero world

Bonds have become very unattractive investments, with a record USD17 trillion of them trading at negative yields.¹ The real yield on global debt – measured by the JP Morgan Government Bond Index – has fallen to an historic low of -1.5 per cent.

But that doesn't mean they can be discarded altogether. The investor's task is to distinguish the expensive from the really expensive.

We aren't attracted to European sovereign and corporate bonds. Europe has a higher proportion of negative yielding bonds than any other region. More than 60 per cent of euro-denominated investment grade corporate debt carry negative yields, an all-time high.

We're also underweight Japanese government bonds, a large proportion of which are also yielding below zero.

Elsewhere, we retain a market-weight stance on emerging market (EM) local currency debt. Even though their yields are, in aggregate, at a five-year low of 5.2 per cent, EM bonds should get a boost from an appreciation in emerging currencies. Our model shows that emerging currencies are undervalued by some 25 per cent versus the US dollar, a discount that is hard to justify given the emerging world's stronger economic growth.

When it comes to currencies, sterling's prospects look bright; we have raised our exposure to overweight. Political and economic uncertainty caused by Brexit has already pushed sterling to its lowest level in 34 years against the dollar. However, we think a lot of bad news is already in the price. Our analysis shows sterling is trading some 12 per cent below what our Purchasing Power Parity model suggests is fair value (see chart).² Consequently, any positive surprise related to Brexit has the potential to trigger a rally in the currency.

FIG. 3 SHAKEN AND STIRRED

Sterling's vs US dollar; % deviation from valuation implied by Purchasing Power Parity model



Source: Refinitiv, data covering period 30.06.1992 - 30.06.2019

Elsewhere, we maintain our overweight stance in the Swiss franc and gold as their safe-haven status should help them outperform in times of increased volatility and high uncertainty.

[1] Source: Bloomberg and Barclays, data as of 30.09.2019

Global markets overview: a style rotation

Global equity markets ended higher in a move led by value stocks, companies with solid if unspectacular profit growth. History shows value stocks outperform their more glamorous 'growth' counterparts when the economy enters the final stage of its expansion. Value stocks have trailed growth stocks by a considerable margin since 2008. But a persistent slowdown in world trade and a recent spike in US Treasury yields appears to have encouraged investors to divert investments to more defensive stocks.

FIG. 4 JAPAN RISING
MSCI Japan, rebased. 30.09.2018 = 100



Source: Refinitiv; data covering period 25.09.2018-25.09.2019 and in US dollar terms

The MSCI ACWI value index ended the month up more than 5 per cent in US dollar terms, beating its growth counterpart by more than 2 percentage points.

The month also saw a wide dispersion between regions and sectors. Japan was the biggest outperformer with a gain of 6 per cent in local currency terms, benefiting from a weaker yen which fell more than 1 per cent (see chart). Financial and energy stocks rose more than 4 per cent. Emerging Asia was the worst region with a decline of 1 per cent.

Oil prices were volatile, with the Brent benchmark posting its biggest jump in about 30 years after attacks on oil facilities in Saudi Arabia sparked fears of supply shortage. The market has since stabilised, with oil prices ending the month up 1.7 per cent. In fixed income markets, emerging local debt was the only sovereign debt asset class that saw positive returns in the month. European sovereign and corporate bonds fell across the board. The euro fell over 1 per cent against the dollar. Gold fell more than 3 per cent.

BAROMETER OCTOBER 2019

Asset allocation

We are negative on both bonds and equities, preferring cash.

Equity regions and sectors

We downgrade emerging market equities and financials and upgrade IT.

Fixed income and currencies

We upgrade sterling to overweight. We maintain our underweight stance in European and Japanese government bonds.

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