PICTET
Asset Management

ASSET ALLOCATION

Equities have a spring in their step

Barometer

March 2017

Pictet Asset Management Strategy Unit

We remain overweight equities and cut bonds to neutral as economic conditions improve and corporate earnings prospects brighten.

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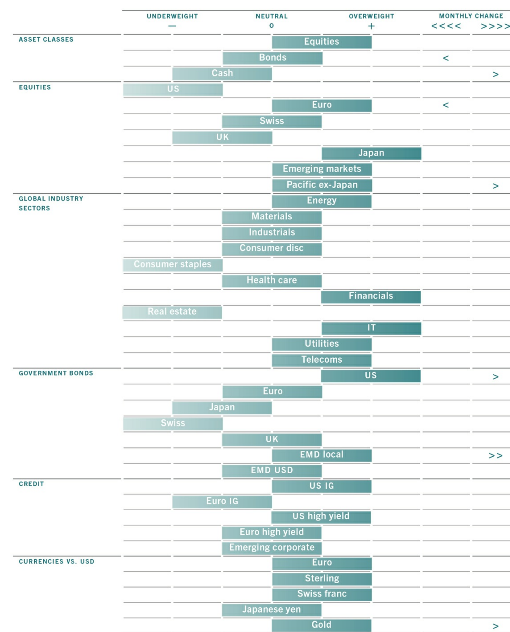
01

Global market overview: equities, gold outperform bonds

February saw stronger global growth, rising inflationary pressures and expectations of tighter monetary policy help equities outpace bonds. Gold also gained.

MONTHLY ASSET ALLOCATION GRID
March 2017



Source: Pictet Asset Management

US stocks delivered among the best returns, rising by some 4 per cent on the month. The S and P 500 and the Dow Jones Index both scaled fresh record highs on expectation that US President Donald Trump's mix of higher fiscal spending and lower corporate taxes will boost economic growth and create jobs.

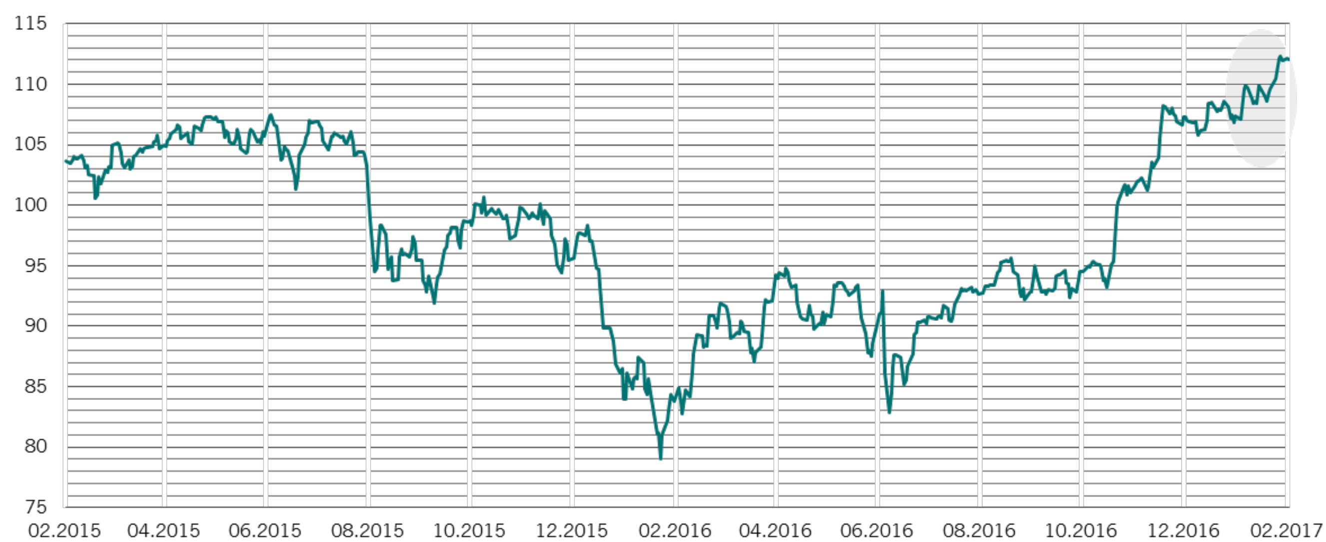
Such policies were also seen as supportive for the US dollar, which gained ground versus most major developed market currencies in February, including the euro, sterling, Swiss franc, and Canadian dollar. The Japanese yen bucked the trend to rise against the greenback, however, as did emerging market currencies, scoring gains ranging from 1.5 per cent for the Brazilian real and Indian rupee to 5.0 per cent for the Turkish lira.

Healthy corporate earnings on both sides of the Atlantic and upbeat leading indicator readings offered further proof of a burgeoning economic recovery. Bond markets moved to price in a near-50 per cent chance of the next US Federal Reserve interest rate hike coming as soon as March – rather than in June, as is our base case scenario.

Somewhat counter-intuitively, some of the most defensive equity sectors delivered the strongest returns, with health care and consumer staples stocks at the top of the leaderboard. Financial stocks rose more or less in line with the broader market, but added to the gains made in recent months (see chart).

FINANCIAL STOCKS STAGE STRONG RECOVERY IN WAKE OF TRUMP VICTORY

MSCI World Financials, indexed



Source: Thomson Reuters Datastream

Commodity-related sectors posted the weakest performance, with energy stocks struggling as oil prices traded within a narrow range.

02

Asset allocation: healthy growth should support stocks

Conditions remain positive for riskier asset classes as economic activity gains momentum – in both advanced and emerging nations.

While the political climate is uncertain in the US and Europe, especially ahead of French presidential elections that could potentially deliver victory to the anti-euro Marine Le Pen of the National Front, corporate earnings prospects remain solid.

Against this backdrop, we are keeping our equity allocation at overweight. We have cut bonds to neutral – maintaining an overweight in US fixed income but an underweight in euro zone investment grade credit due to the risks associated with the French elections and political upheaval in Italy.

Business cycle indicators continue to paint an upbeat picture of the global economy. Our proprietary leading indicators are at their strongest level since December 2013, while the world purchasing managers' index (PMI) stands at levels not seen since April 2011. Most importantly, the recovery in economic momentum has been a synchronised one, with all regional leading indicators having moved above their three-year averages. The most recent reading of world industrial production showed that growth has accelerated to an annualised 2.8 per cent, spiking above the long-term average of 1.7 per cent.

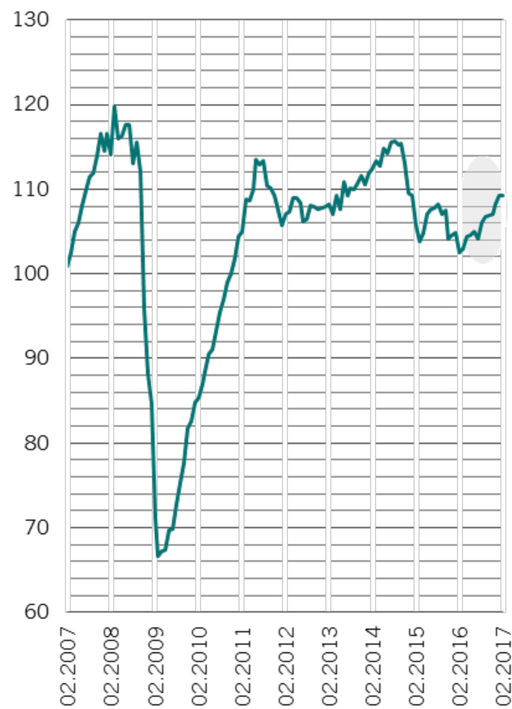
The US remains the best performing economy, characterised by strong consumption and a rebound in investment. However, the rate of expansion may have already peaked and we expect the core inflation rate to ease to 2.1 per cent by year end from its current 2.3 per cent.

The euro zone economy is expanding at a fair pace, despite simmering political risks ahead of elections in France, the Netherlands and Germany. Consumer spending remains the primary source of growth. Labour market conditions and manufacturing growth are also improving. The EU commission's latest economic sentiment indicator suggests the region's growth should accelerate to 3 per cent annualised.

Japan’s leading indicator rose for a seventh month in a row while its PMI hit a four-year high, supported by rising exports. A rise in global exports also underpinned economic momentum in China, where our leading indicators hit their highest since December 2013. Capital outflows from China, which have been a concern, seem to have eased after policymakers stepped up scrutiny of cross-border flows and the yuan steadied following a rise in Chinese short-term rates. Other emerging economies are also drawing support from better external demand, as well as from improved global dollar liquidity.

COMPANIES' EARNINGS PROSPECTS IMPROVING

Earnings per share, MSCI World constituents, indexed



Source: Thomson Reuters Datastream

Our **liquidity** analysis supports our bullish stance on stocks. Liquidity conditions have improved in recent months, thanks primarily to a benign shift in the US, where the Fed has slowed the pace of monetary tightening in the money markets. Bearing testimony to the increased availability of US dollar funding worldwide, the cost of securing dollar funding in the cross-currency basis swaps market has eased in recent months. Given these developments, we think the possibility for a March rate hike in the US is lower than currently anticipated by the market. This is because the Fed has in the past prepared the ground for a rate hike by tightening dollar liquidity beforehand. A source of concern is the rapid deterioration in bank lending in the US, which is now contracting for the first time in five years.

Our **valuation** readings continue to show equities are expensive, especially in the US, where the benchmark S and P 500 index has gained 12 per cent since the presidential election. The index's three-month realised volatility has fallen to a 21-month low of 6.7 per cent yet US stocks are close to being the most expensive ever against their European and Japanese peers. Another metric that illustrates the lofty valuations in the US is its stock market capitalisation relative to GDP — Warren Buffet's preferred gauge. At 126 per cent, the ratio is only 9 percentage points below its all-time high.

However, equities could continue to draw support from growth in corporate earnings. So far in the fourth quarter reporting season, US and European companies reported 6-7 per cent growth in earnings per share (EPS), the best in over two years. Profit margins have also started to rebound after four quarters of contraction. EPS growth could, in our view, beat consensus forecasts this year for the first time since 2010. In other markets, European local currency debt is the cheapest asset class while US government bonds remain inexpensive relative to most of their peers.

Our **technical** signals show scope for equities to build on their recent gains. While the fall in the price of options that insure against down markets points to complacency starting to set in, our sentiment index in aggregate does not suggest the equity market is overbought. Our technical indicators are more bearish for bonds on the whole, however.

03

Regional equities: valuation is the US's stumbling block

The world economy is on a strong footing, corporate profits are rising and annual global exports growth is at two-year high of 3.8 per cent. On the face of it, the road is clear for further equity market gains. Look closer, however, and there are a number of potential potholes.

For US equities, our main concern is valuation. On our fair value 12-month price-earnings ratio model, the S and P 500 is now two standard deviations above its 10-year average. Longer-term gauges such as the Shiller price-earnings ratio show US stocks are at their most expensive levels since the dot.com bubble of 1999-2000.

There are two additional warning signs. Firstly, these high valuations coincide with unusually low levels of volatility. One indicator of the market's vulnerability to a sell-off is the unprecedented gap that has opened up between US stocks' price-earnings multiples and their implied volatility. Expressed as a ratio, the gap between the S and P 500 index price-earnings multiple and the VIX index is now at 1.6 times, an all-time high.

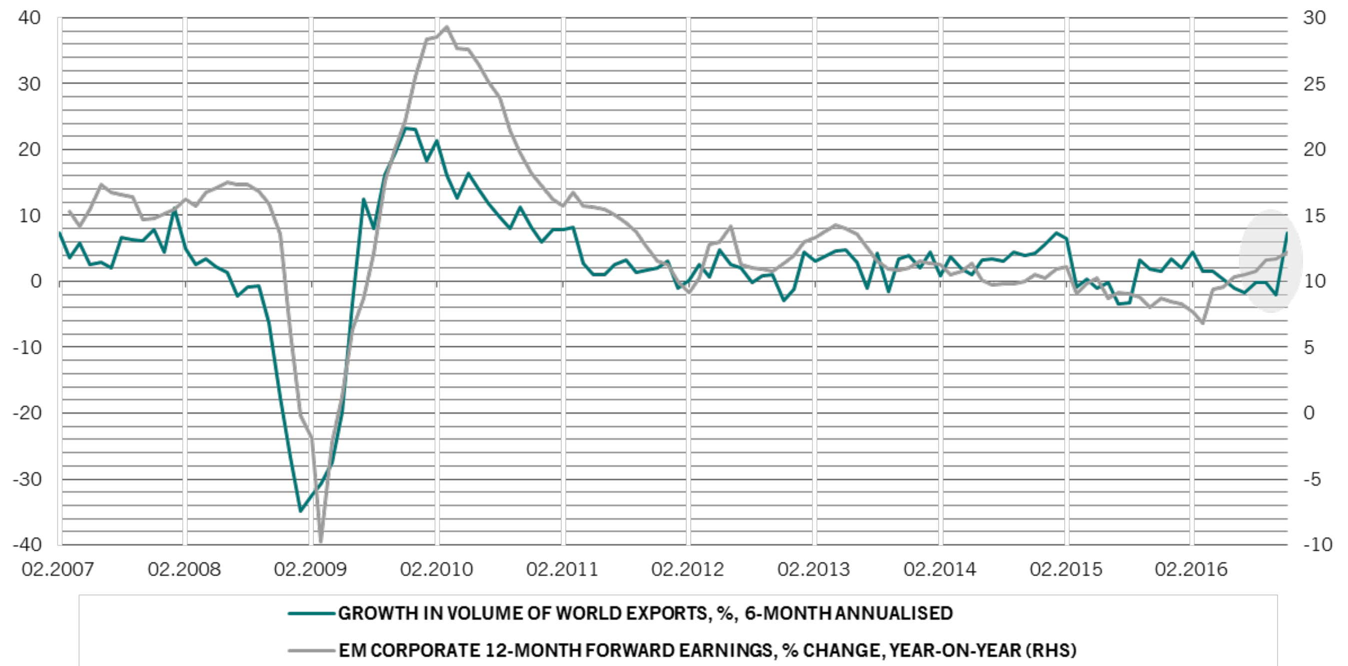
Secondly, the latest rally in US stocks is not backed up by upward revisions in analyst forecasts. Although earnings are rising and expected to continue to do so, consensus analyst profit forecasts have been stable since November. Together, this suggests a short-term pullback is increasingly likely and thus supports our underweight stance on US equities.

Europe's pothole, meanwhile, is a political one. We are still upbeat on economic prospects and the potential for positive surprises. The latest results season has brought fresh good news, as 56 per cent of STOXX 600 companies delivered forecast-beating earnings.

But with far right parties gaining ground in opinion polls ahead of both a Dutch general election in March and French presidential ballot in April, we think now is a good time to scale back exposure to European stocks, albeit retaining our overweight stance.

Conversely, we are turning more optimistic on Pacific ex-Japan equities, raising them to overweight from neutral. This tallies with a more upbeat view on the region's economic prospects thanks to rising global exports. Australia is on track to snatch the record for the world's longest run without a recession from the Netherlands. The more balanced outlook for China – thanks in part to the authorities' focus on financial stability – should also help.

REBOUND IN DEVELOPING WORLD EXPORTS COULD DRIVE EM PROFIT GROWTH HIGHER



Source: Bloomberg

We also remain positive on Japan and emerging markets. As the chart shows, a pick-up in exports among developing economies tends to be associated with a positive shift in EM companies' earnings prospects. In nominal terms, exports from EM economies have improved steadily over the course of the year and are now growing at a rate of 2.8 per cent per year compared to a decline of over 10 per cent 12 months ago. To us, this suggests EM companies should be able to deliver the forecast 15 per cent rise in profits over the next 12 months, their best showing since 2011.

On a sector basis, the recovering global economy bodes well for cyclical stocks. The problem is this opportunity comes at an increasingly high price. We believe some of the best trade-offs between current value and future growth potential can be found in financials and IT. Consumer staples, on the other hand, remain our biggest underweight. The sector is the second most expensive on our models, after industrials, and is likely to be hit hard by rising inflationary pressures. After having lagged the broader index for quite some time, utility and telecom stocks now look good value; we are consequently overweight both sectors.

04

Fixed income: economic revival underpins EM debt

A sharp jump in emerging market (EM) nominal export growth and a muted inflationary backdrop across the developing world underpin our case for upgrading EM local currency debt to overweight from underweight this month.

China's economic revival has been particularly noteworthy, with our leading indicator for the country notching up its highest level since December 2013. That's notwithstanding an increase in Chinese short-term rates as Beijing shifts its attention from boosting growth to maintaining financial stability.

Meanwhile, there are signs that India will see a V-shaped recovery following the steep economic downturn triggered by last autumn's shock demonetisation. On balance, our economists think that the large majority of EM central banks are inclined to keep policy steady or cut rates, suggesting yields on local currency bonds could fall further. At the same time, the asset class's valuations are attractive, with EM bonds' yield spreads over global government debt at more than 80 basis points above their long-term average (see chart).

Elsewhere in fixed income, we've increased our exposure to US Treasury bonds as a hedge against the risk that global economic growth fails to be as robust as we anticipate, as well as against potential upheaval in Europe.

Unorthodox policy shifts from the Trump administration – including but not limited to the President's border tax proposal – could yet derail what is proving to be positive economic momentum in the US and elsewhere. In Europe, meanwhile, a victory for the National Front's Marine Le Pen in the French presidential election would cast fresh doubt on the single currency region's political sustainability and could ignite a fresh euro zone crisis. Against all these risks, we believe the cheapest form of insurance is longer-dated US government debt. Although 30-year Treasury yields have largely treaded water during the past couple of months, they remain around 80 basis points above their levels from last autumn.

EM LOCAL CURRENCY DEBT EXHIBITS ATTRACTIVE VALUATIONS

Yield spread, percentage points, JPMorgan GBI-EM Index vs JPMorgan Global Government Bond Index

Source: Bloomberg

To further contain the threat from political upheaval, we remain underweight European corporate debt. Yield spreads on European corporate bonds have been unusually stable compared to those on securities issued by sovereign borrowers such as Italy. To us, that suggests a sharp sell-off could soon unfold.

Reinforcing our underweight stance on euro investment grade debt, the asset class is close to the most expensive it has ever been, trading at around 122 basis points above German Bunds.

Separately, although Europe's political upheaval appears to suggest the euro might weaken, we would argue that the dollar is more likely to depreciate in the coming months.

Not only has Trump been campaigning against the strong dollar, but if the Fed fails to tighten policy by March, the greenback could slide further over. Consequently, we have kept our overweight on European currencies versus the dollar – primarily the euro, Swiss franc and sterling. Our view on the dollar has also led us to upgrade our stance on gold to overweight from neutral. Gold offers a hedge against political risk while investor positioning in the precious metal is also excessively bearish.

05

In brief

MARCH

2017

Asset allocation

Keeping overweight stance on equities and downgrading bonds to neutral as robust global economic momentum underpins riskier assets

Equities

Staying underweight in the US given unattractive valuations; turning more optimistic on Pacific Asia

Fixed Income

Upgrading EM local currency debt to overweight as the exports outlook brightens

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