PICTET
1805
Asset Management

TACTICAL ALLOCATION
MONTHLY UPDATE

April 2016 BAROMETER

Stocks to recover but risks loom

GLOBAL ASSET CLASSES

We stick to our overweight stance on equities and remain underweight bonds as economic conditions remain favourable.

EQUITY REGIONS AND STYLES

Emerging market stocks should do well as China's economy continues to stabilise; we also like European stocks.

EQUITY SECTORS

We upgrade telecoms to overweight on valuation grounds and cut our exposure to utilities.

FIXED INCOME

We reduce local currency EM debt to neutral and raise dollar EM bonds to overweight; we remain overweight US high-yield debt.

	UNDERWEIGHT —		NEUTRAL 0		OVERWEIGHT +	MONTHLY CHANGE <<<<	>>>>
ASSET CLASSES				Equities			
		Bonds					
			Cash				
EQUITIES		US					
				Euro			
			Swiss				
			UK				
				Japan			
				Emerging markets			
			Pacific ex-Japan				
GLOBAL INDUSTRY SECTORS			Energy				
				Materials			
			Industrials				
				Consumer disc			
		Consumer staples					
			Health care				>
			Financials				
				IT			
	Utilities					<	
					Telecoms		> >
FIXED INCOME AND GOVERNMENT BONDS		US					
		Euro					
	Japan						
		Swiss					
		UK					
			EMD local			<	
				EMD USD			>
CREDIT		US IG					
			Euro IG				
					US high yield		
			Euro high yield				
			Emerging corporate				
CURRENCIES VS. USD			Euro			<	
			Sterling				>
			Swiss franc				
			Japanese yen				
			Gold				

THE PICTET ASSET MANAGEMENT STRATEGY UNIT (PSU)

is the investment group responsible for providing asset allocation guidance across stocks, bonds, cash and commodities.

A strong rebound for stocks, emerging markets shine

Bucking a trend: equities rise as US dollar weakens

Source: Thomson Reuters Datastream

Equities bounced higher in March, outperforming bonds after dovish comments from US Federal Reserve chair Janet Yellen prompted investors to scale back expectations over the pace and scale of future US interest rate hikes. A fall in the US dollar (see chart) boosted dollar-sensitive commodity prices and emerging market stocks.

The recovery in emerging assets was supported by a sharp pick up in portfolio inflows. According to the Institute for International Finance (IIF), foreigners pumped some USD37 billion back into emerging stocks and bonds in March, the highest in nearly two years.

Although that was a fraction of last year's USD730 billion total net capital outflows from emerging economies, it was enough to lift emerging markets across the board. Emerging market equities rose by over 10 per cent to become the best performing asset class. Latin American stocks, which had fallen sharply earlier in the year, rebounded 20 per cent. Investments into Brazilian and Korean equities and Indonesian bonds were especially high, the IIF said. Separately, in developed stock markets, the rally took the S&P 500 Index back above its closing level for 2015.

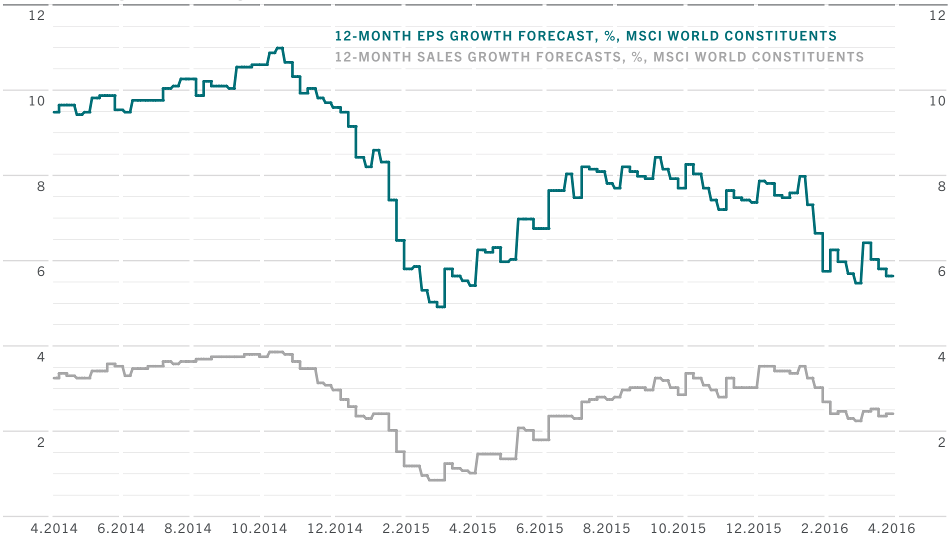
An 8-percent rally in oil prices and further evidence of a stabilisation in China's economic growth lifted energy and material stocks. Some defensive stocks such as telecoms and utilities also performed well.

Investors' renewed appetite for riskier assets extended to fixed income, where emerging market local currency debt gained some 10 per cent. Within credit, European high-yield debt rose more than 5 per cent after the European Central Bank announced plans to extend its asset purchase programme, saying it would start buying corporate debt and launch four new rounds of cheap bank financing. US high yield, which has seen yields spike in recent months, saw some respite, ending the month in positive territory. In government bond markets, meanwhile, yields on developed market sovereign debt hit an all-time low of 1.1 per cent. Long-dated Japanese bonds saw exceptionally strong gains, with the 30-year note rallying more than 20 per cent on the quarter, its strongest three-month return since 1998.

In the currency markets, the euro rose against the dollar, as did several emerging market currencies. The Russian rouble, Brazilian real, and Colombian peso saw gains of 4.5-7 per cent. Bucking the trend was the UK sterling, which continued its decline against the dollar as investors saw an increased risk of the country voting to leave the EU in June's referendum.

Keeping a pro-risk stance

Earnings and sales growth expectations too low?



Source: Thomson Reuters Datastream

After a sharp sell-off in equities at the start of the year, investors appear to have become more confident about the outlook for the global economy.

With the Fed reluctant to raise interest rates anytime soon and evidence that China's economy is stabilising, we too are optimistic about the world's prospects, and have decided to maintain our overweight stance on equities and our underweight on bonds.

Still, while we expect see to see the economy grow moderately over 2016, the sheer intensity of the recent rally suggests investors should probably tread a little more carefully in the next few weeks. With that in mind, we have sought insurance against the risk of a market correction by raising our exposure to longer-dated US Treasuries.

Our BUSINESS CYCLE indicators show the US economy is on track to deliver modest growth of around 2 per cent this year. Manufacturing sector activity has started to stabilise, while consumer spending remains resilient and labour market conditions continue to be strong. As a result, our proprietary model puts the probability of a US recession over the next 12 months at just 10-15 per cent, compared with over 30 per cent priced in by the equity market. We expect a rise in core CPI – which hit a seven-year high of 2.3 per cent in February – to be temporary as it has not been induced by any acceleration in wage costs. Inflation is therefore likely to stay within the Fed's comfort zone this year.

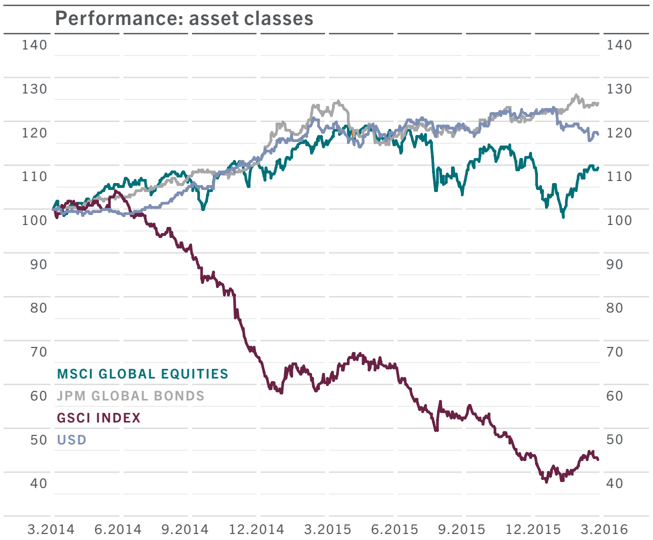
We expect more moderate expansion in the euro zone, supported by private consumption which remains the main engine of growth in the region. Industrial activity is mixed, while the outlook for credit growth improving – the latest data showed that lending to the bloc's companies and households grew at its fastest pace since late 2011 in February. However, our leading indicators suggest growth momentum is losing steam.

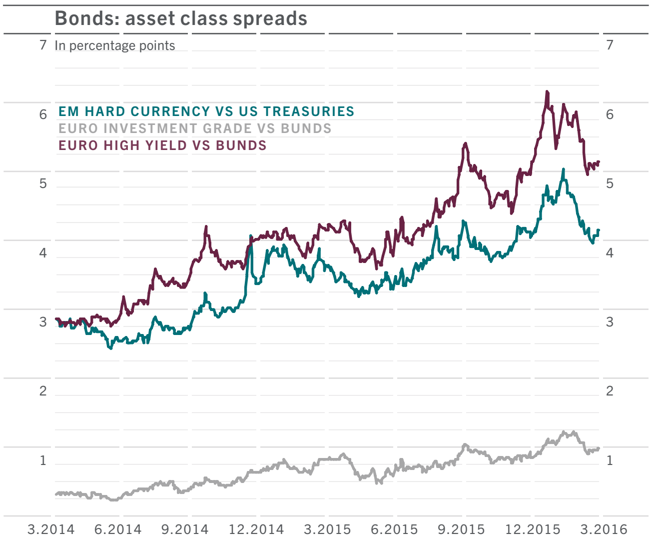
Further supporting the region's economic recovery is the ECB's new stimulus package, under which it has cut its three key interest rates and expanded its asset buying scheme to EUR80 billion a month to include high-grade corporate bonds. The central bank's additional move to resume its long-term refinancing operation (LTRO) – its bank funding scheme – could prove to be a major boost to credit growth as it effectively involves paying banks to lend to consumers and businesses.

Our indicators for Japan paint a less convincing picture. Inflation is likely to remain subdued as the Bank of Japan's negative interest rate policy is showing little sign of filtering through to the real economy. Japanese financial markets experienced huge capital outflows as foreigners cut back on risk and domestic investors sought higher yields abroad. We believe that the world's third largest economy will need more supportive policy, including fresh easing from the BOJ and fiscal stimulus from the government, to stave off risks of deflation.

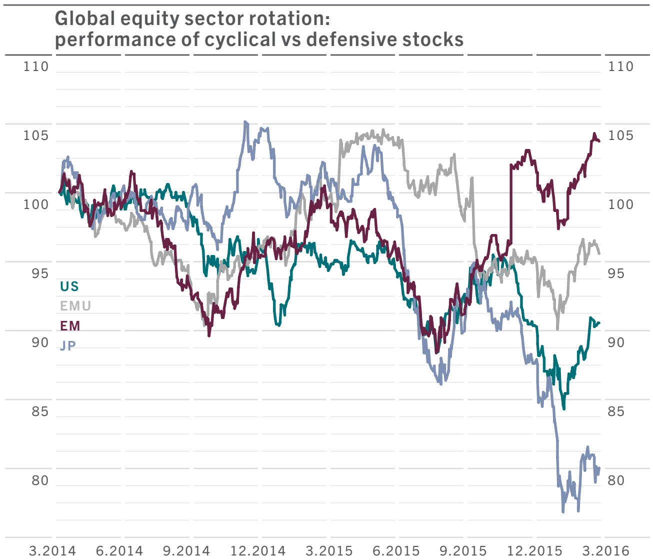
In China, industrial activity remains sluggish but the property sector, which accounts for around 15 per cent of the economy, is recovering after a slew of stimulative government measures. Financial market conditions have stabilised after a New Year wobble and we expect

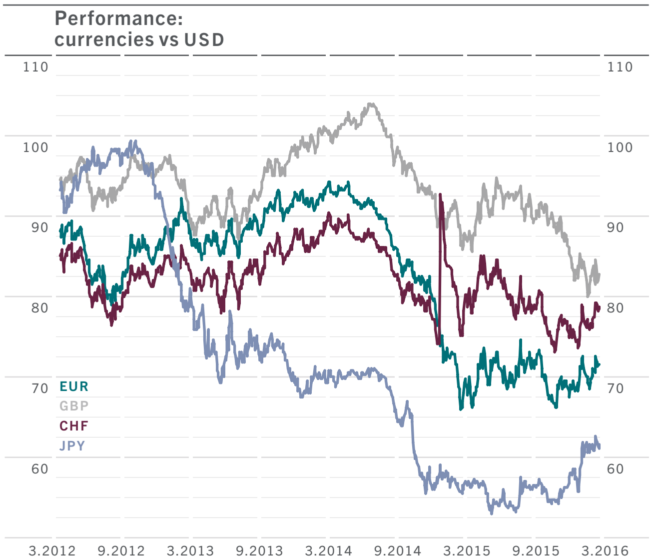
Major asset classes





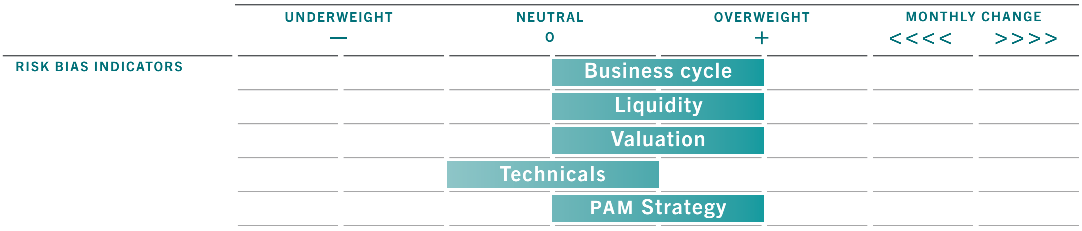
Equity sector rotation and currency performance



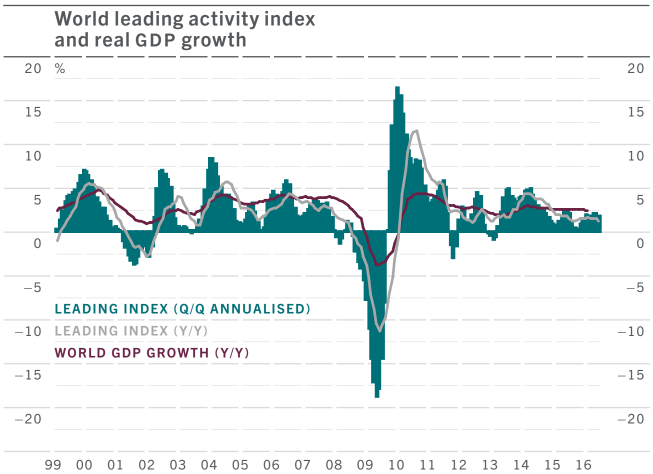


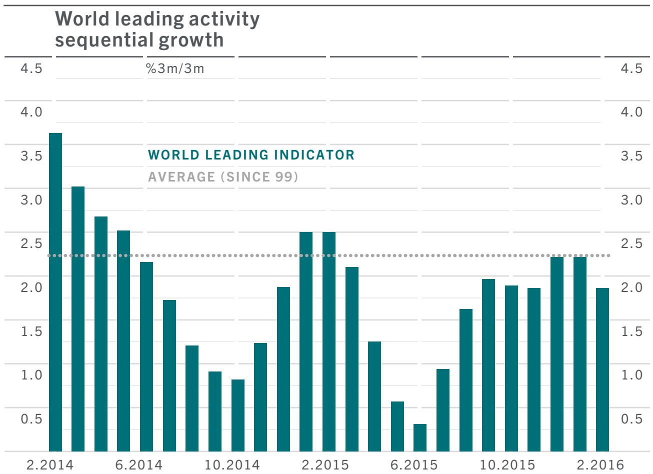
Source: Pictet Asset Management,
Thomson Reuters Datastream / JPM and BoA Merrill Lynch

Risk bias indicators

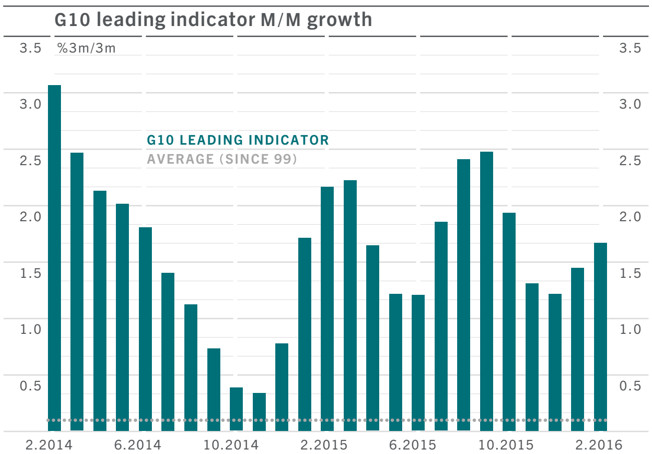


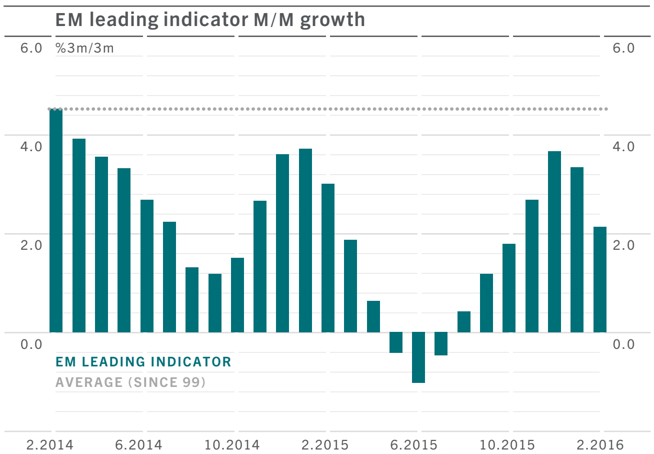
Business cycle: World economic growth remains moderate





Economic momentum in G10 picks up further





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

Valuation: Equity markets and sectors

Countries and sectors

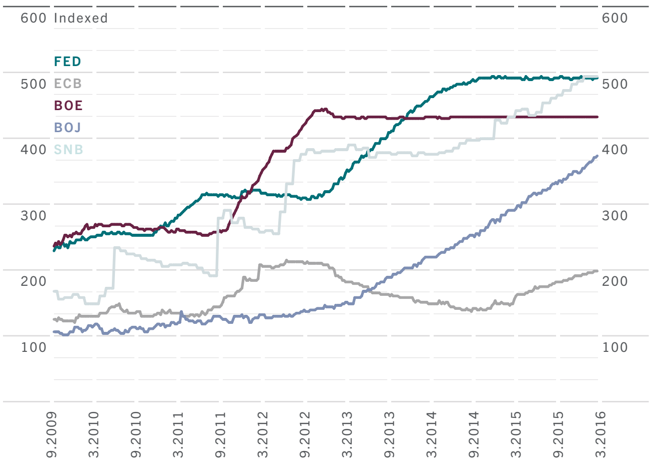
MSCI REGIONS	EPS GROWTH 2016	EPS GROWTH 2017	SALES GROWTH 2016	SALES GROWTH 2017	PE 2016	PE 2017	PB 2016E	P/SALES 2016E	DY 2016E
US	1%	14%	1%	6%	17.4	15.3	2.6	1.8	2.2%
EUROPE	0%	14%	0%	5%	15.6	13.7	1.7	1.2	4.5%
EMU	3%	12%	1%	4%	14.1	12.6	1.4	0.9	3.7%
SWITZERLAND	0%	11%	1%	4%	16.9	15.2	2.3	2.1	3.5%
UK	-5%	19%	-4%	9%	16.6	14.0	1.7	1.2	4.4%
JAPAN	12%	8%	1%	3%	12.8	11.9	1.1	0.7	2.4%
EM	8%	15%	2%	9%	12.5	10.9	1.3	0.8	2.8%
NJA	4%	12%	5%	9%	12.6	11.3	1.3	0.7	2.8%
GLOBAL	**3%**	**14%**	**1%**	**6%**	**15.9**	**14.0**	**1.9**	**1.3**	**2.9%**

MSCI REGIONS	EPS GROWTH 2016	EPS GROWTH 2017	SALES GROWTH 2016	SALES GROWTH 2017	PE 2016	PE 2017	PB 2016E	P/SALES 2016E	DY 2016E
ENERGY	-38%	97%	-11%	19%	33.5	17.0	1.2	0.8	4.6%
MATERIALS	4%	21%	-5%	5%	18.3	15.0	1.6	1.0	2.7%
INDUSTRIALS	9%	11%	3%	4%	16.1	14.5	2.3	1.0	2.6%
CONSUMER DISCRETIONARY	11%	12%	5%	5%	15.9	14.2	2.5	1.1	2.1%
CONSUMER STAPLES	5%	10%	3%	5%	21.7	19.7	4.0	1.3	2.9%
HEALTH CARE	7%	11%	8%	6%	16.1	14.5	3.3	1.8	2.1%
FINANCIALS	2%	9%	2%	5%	11.5	10.6	1.0	1.5	4.1%
IT	4%	13%	3%	5%	16.8	14.9	3.1	2.2	1.7%
TELECOMS	8%	9%	4%	2%	15.6	14.4	2.1	1.3	4.1%
UTILITIES	-5%	4%	0%	2%	15.6	15.0	1.5	1.0	3.8%

BAROMETER APRIL 2016

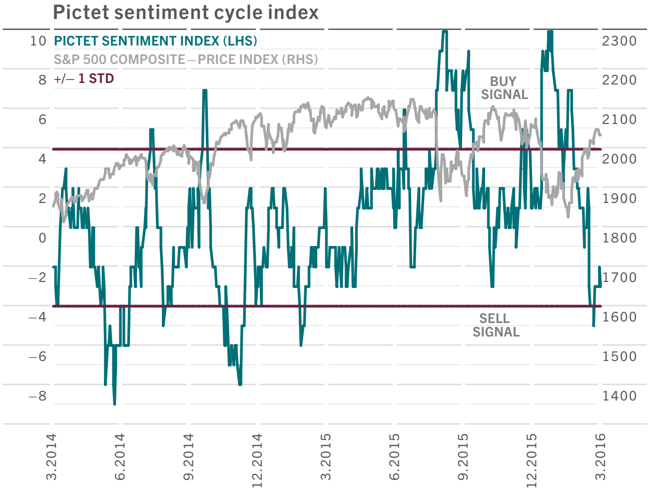
Liquidity: FED begins to hike rates, but stimulus provided by other central banks

Size of Central Banks' balance sheets



Sentiment indicator shows risk of market correction

Pictet sentiment cycle index



Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch the People's Bank of China to ease monetary policy again this year to support the economy.

Countries in the rest of the emerging world seem to be on divergent paths. Those reliant on commodity exports continue to suffer from weak raw materials prices: leading indicators for this group are stuck below the three-year moving average. Manufacturing exporters are faring better, however, reflecting improving momentum in external demand.

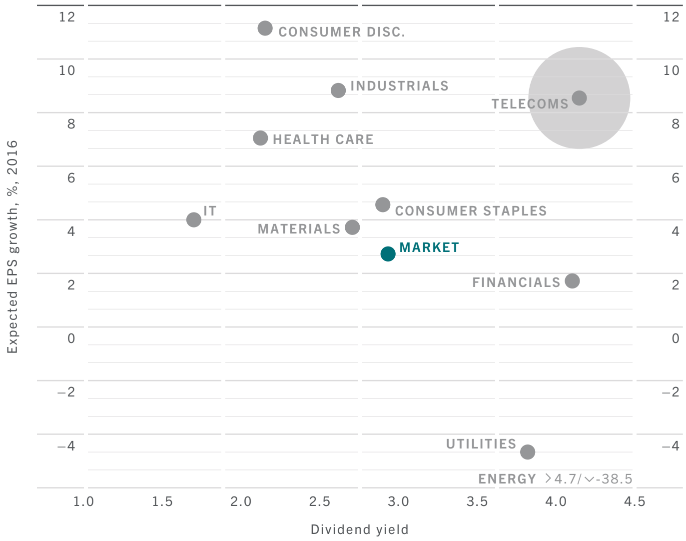
Our LIQUIDITY readings remain positive, thanks to the latest monetary easing from the ECB and the BOJ. However, the Japanese central bank's radical stimulus steps, which began in April 2013, have so far failed to lift Japan out of stagnation and further deterioration is likely to heighten calls for more unorthodox stimulus. Similarly in the euro zone, inflation has been under the ECB's target of close to 2 per cent since early 2013 and the ECB may come under pressure to introduce fresh measures, which would be positive for global liquidity. The volume of excess liquidity – or the difference between the rate in the growth of money supply and nominal GDP – remains ample worldwide even though it appears to be peaking.

Our VALUATION signals suggest that risky assets continue to look attractive relative to government bonds but after the recent rally, the absolute valuation has returned to its historical range, with global equities trading at 16 times prospective earnings and a price to book ratio of two. At the same time, the market has seen a significant dispersion in valuations, both among regions and industry sectors. US equities and global consumer staples stand out as the most expensive, emerging Asia, Japan and financials are the cheapest stocks. A decline in consensus expectations for corporate earnings growth is a red flag, especially for US companies, whose profit margins are falling from record highs. The good news here, however, is that consensus forecasts for global revenue growth in 2016 are already at an extremely depressed level of just 1 per cent – well below the underlying growth rate of global GDP. That looks overly pessimistic.

Our TECHNICAL indicators show that risky assets are now in overbought territory following the recent rally. In addition, gold and the Japanese yen have performed well during the period of recent market stress, and as a result they too look ripe for a correction. Meanwhile, the cost of insuring against a market fall in the options market, as indicated by the VIX index, has fallen to levels that suggest investors may have become complacent.

Emerging markets and Europe to ride out political risks; telecoms upgraded

Telecoms: attractive yield, attractive EPS growth



Source: Thomson Reuters Datastream; data as of 30.03.2016

The growing likelihood of impeachment proceedings against Brazil's President Dilma Rousseff and the UK's looming referendum on EU membership could be seen as reasons to retrench from emerging market and European equities.

Yet while it is clear these asset classes have become more vulnerable to political upheaval, there are reasons to believe that both can build on their recent gains.

For their part, emerging market stocks should continue to benefit from monetary and fiscal stimulus from China, which is taking assertive action to stabilise growth. By our calculations, China's government spending is rising at an annual 25 per cent compared to a long term average of about 20 per cent.* This fiscal boost has been matched by evidence of a successful transmission of monetary stimulus: property sales grew by a yearly 28 per cent in the January to February period while infrastructure investment grew at an annual 10.2 per cent in January versus 8.2 per cent the previous month. The manufacturing sector is also showing signs of life: China' PMI manufacturing index rose to above 50 in March, for the first time since July 2015.

The technical picture is also positive for emerging market equity. With the asset class having witnessed heavy investment outflows over the past five years, there are tentative signs that previously bearish investors are beginning to rebuild their holdings. Net portfolio inflows into emerging market assets from foreign investors have been positive for two months in a row, the first time that has happened since June 2015, according to IIF figures. At USD37 billion, March inflows were more than 50 per cent above the monthly average seen over 2010-2014, the IIF said.

European stocks also look appealing. Although the market has recently managed to recoup around half of the losses it has suffered since the beginning of the year, its performance continues to lag that of the US – US stocks are virtually flat year to date while their European counterparts are down more than 5 per cent (or 10 per cent for euro zone stocks). This underperformance is unjustified in our view. Even if the risk of a UK exit from the EU is a concern for investors, the euro zone can count on continued monetary stimulus from its central bank. This, and the fact that expectations for both corporate earnings and sales growth are already at very low levels, suggest to us that European equities could prove to be a bright spot in the near term. Further reinforcing our positive view are the signs that emerge from investor positioning. European stocks have seen heavy investment outflows in 2016, which indicates that sentiment towards the asset class is overly bearish.

We like Japanese stocks for similar reasons – our technical indicators show that investment flows out of the asset class have been running at exceptionally high levels in recent months as non-Japanese market participants wound down their positions, partly in response to a rise in the Japanese yen. We expect this trend to reverse over the coming months as the central bank appears poised to unleash additional monetary stimulus. Still, risks are growing. Weak macro-economic data and disappointing wage settlements suggest growth could slip in the short term.

Rotating capital among industry sectors arguably offers greater opportunities for securing attractive returns than shifting investments among equity regions. That is because the dispersion of returns among industry sectors has been greater over the past several months. As the chart shows, when industry sectors are ranked by their EPS growth and dividend yield, significant differences in valuation emerge. Telecom companies stand out as among the most attractively valued stocks – and we have accordingly increased our exposure to overweight. The sector is also reaping the benefits of industry consolidation and the easing of regulatory pressures. Indeed, for the first time in 20 years, prices for telephone services are rising in both Europe and the US – suggesting an end to the significant squeeze on profit margins that telecom companies have experienced in the past decade.

High-yielding utilities, by contrast, are weighed down by weak earnings prospects. What is more, with global bond yields at all-time lows, there is limited room for such stocks to gain. This is because the performance of utility stocks and government bonds are closely correlated. As a result, we have further cut our exposure to the sector. We have also upgraded health care to neutral. Having lagged the MSCI World AC Index by 10 per cent this year, health stocks are attractively-valued.

* Figures relate to the 12-month moving average of government spending growth

High yield and emerging dollar sovereign debt look good value

Spreads on EM dollar bond spreads climbing to attractive levels

Aggregate spread, percentage points, JPM EMBI index vs US Treasuries

Source: Bloomberg

March saw investors rediscover their appetite for higher-yielding securities, with emerging market and speculative-grade bonds delivering solid returns on the month. The rebound has served to push US high yield and local currency emerging market debt – markets in which we have been overweight for a number of months – firmly into positive territory for the quarter. US high yield is now sporting a gain of some 4 per cent year-to-date while emerging local currency debt is up 6 per cent. The bounce has led us to reassess some of our more tactical positions, particularly within emerging markets.

We have decided to scale back our exposure to local currency emerging market debt to neutral following its strong run and upgrade its dollar-denominated counterpart to overweight. Dollar-denominated emerging sovereign debt looks attractive, particularly when compared with investment grade corporate debt. Triple-B rated emerging market government debt and similarly-rated corporate bonds offer virtually the same yield pick up over US Treasuries of some 250 basis points. While such a spread looks justifiable for company bonds, it seems excessive for emerging sovereign borrowers, chiefly because it fails to take into account a government's ability to reduce dollar debt and finance itself in domestic currency. The decision to scale back exposure to local currency emerging market sovereign bonds is linked to our view on the US dollar. The US dollar – which is down some 6 per cent from its January peak against major currencies – could reverse course over the short term, which would have negative implications for emerging currencies.

We have chosen to maintain our overweight stance on US high yield debt. Even though the market has staged an impressive rally, the asset class remains inexpensive. Spreads on US high yield bonds – currently at around 700 basis points – indicate a near-70 per cent probability of recession in the US over the next 12 months, which looks highly unlikely in our view. Default rates for high-yield bonds are currently running at a below- average 3.6 per cent, according to Moody's – which means spreads provide ample compensation against the risks inherent in such securities, even if the financial health of energy companies, a big part of the market, continues to deteriorate in the coming quarters.

We find very little value in government bonds now that their yields are at record lows. The yield offered by government bonds in JPMorgan's government bond index was just 1.1 per cent at the end of March – which looks excessively low at a time when nominal economic growth appears to be stabilising.

Still, as we are concerned about the possibility of a lurch into deflation, we have decided to make a tactical allocation to long-dated US government bonds, which should insure our portfolio against the risk of an unexpectedly sharp fall in inflation

The 30-year US Treasury offers a good yield pick-up, offering a yield of around 80 basis points above the 10-year note – a spread that is 30 basis points higher than the long-term average. As far as currency positioning is concerned, we have scaled back our stance on the euro to neutral as we believe the currency could weaken against the dollar if polls begin to show the UK might vote to leave the EU. But with sterling having largely priced in this risk, in our view, we have shifted our stance on the UK unit to neutral.

Issued April 2016

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

TECHNICALS

Pictet sentiment index (investors' surveys, tactical indicators)

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