PICTET
1805
Asset Management

TACTICAL ALLOCATION MONTHLY UPDATE
FOR PROFESSIONAL INVESTORS ONLY

January 2017

BAROMETER

A conflict between growth and liquidity

GLOBAL ASSET CLASSES

We remain neutral on bonds, equities and cash given the conflicting forces of stronger global growth and tighter liquidity.

EQUITY REGIONS AND STYLES

Prospects for European equities have turned more positive, at least in the short term.

EQUITY SECTORS

We turn more cautious on industrials following the recent rally.

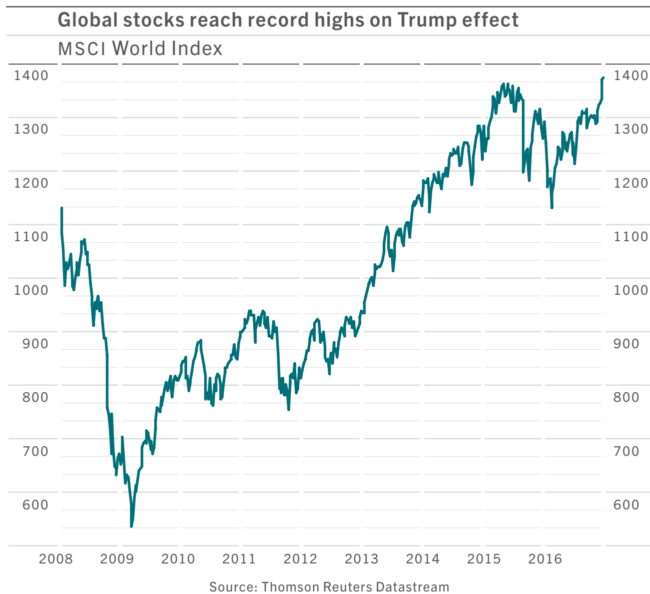
FIXED INCOME

Post US election shakeout has opened up some value in the bond market, particularly in US investment grade 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			
			Real estate				
					IT		>
		Utilities					>
				Telecoms		<	
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.

Trump keeps America buoyant



The Trump effect lifted US equity prices further during December as markets continued to price in expectations that the US president-elect would implement a number of business-friendly election promises. Not only is there the prospect of a significantly lower corporate tax rate, but also of a major fiscal stimulus package, potentially worth USD500 billion over the coming years. US equities were up more than 2 per cent on the month and up over 12 per cent on the year, with benchmark market indices marking a series of new highs during December.

Outside the US, equity market returns were affected by the persistent strength of the US dollar. While UK stocks continued to do well in sterling terms, up nearly 5 per cent during December and almost 20 per cent on the year, in dollar terms the shares were down on the year. European equities – despite ripping nearly 7 per cent higher on the month in local terms as they played catch-up with the wider equities rally – rose less than 1 per cent during 2016 in dollar terms. Emerging market shares ended the month in the red by 1 per cent, taking their 12-month return down to 10 per cent.

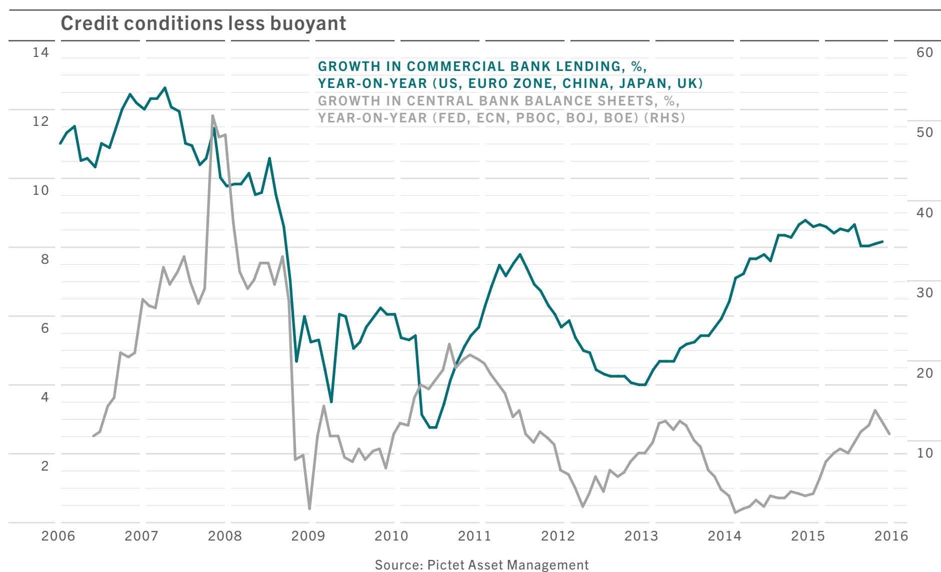
Extractive industry sectors were lifted by the continuing rally in oil and commodities. Energy shares were up more than 3 per cent on the month and up nearly a third on the year in local currency terms; materials gained 1 per cent in December, leaving them some 24 per cent up in 2016.

Government bonds largely struggled during the month, taking the lead from the same fundamentals driving the dollar higher: expectations that stronger US economic growth would make the US Federal Reserve speed up monetary tightening, a view underscored by its December rate hike. Global bonds were broadly flat on the month.

Corporate credit fared a bit better, picking up ground on the back of investor optimism that the Trump effect on corporate balance sheets would offset the impact of rising funding costs. Emerging market local currency and dollar bonds also ended the month in positive territory.

In foreign exchange markets, most currencies weakened against the dollar, with the euro and yen losing over 2 per cent on the month.

Remain neutral on equities as short-term risks rise



Source: Pictet Asset Management

Optimism for the global economy is running high after an eventful year, with growth having remained resilient in the face of political upheaval in the US and Europe.

The strong economic momentum in the US, the prospect of a fiscally-expansive package of measures from a Trump administration, and continued monetary stimulus mainly from the euro zone and Japan should underpin equities over the course of the year.

However, the outlook for riskier asset classes is less clear in the near term. Market euphoria over Trump's pro-growth proposals could fade somewhat as political realities bite, while China's slowing economy and mounting debts could induce fresh market turmoil at a time when Beijing is tightening monetary policy as it seeks to stop asset bubbles forming.

Additional interest rate hikes by the Fed – coupled with a steady draining of central bank stimulus worldwide – could also weigh on financial markets, particularly on emerging market assets. Indeed, we note a distinctly hawkish tilt in the Fed's stance, with the committee's rate projections shifting higher.

Against this backdrop, we remain neutral on equities, bonds and cash, preferring to stay on the side lines but ready to increase our equity exposure later in 2017.

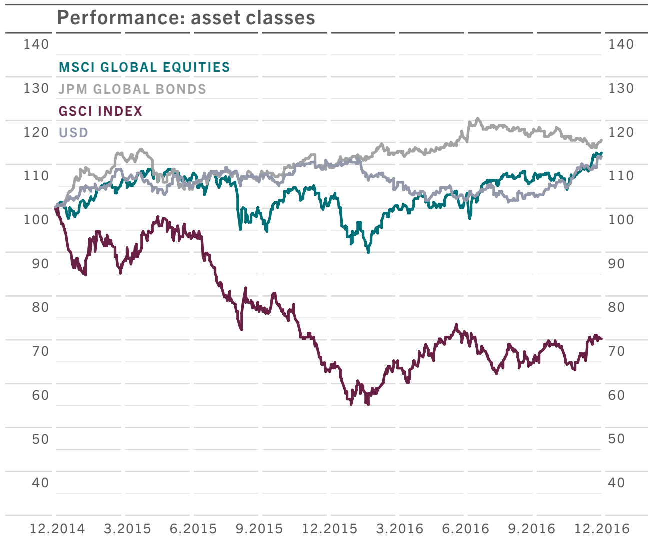
Improving economic conditions in the developed world have lifted our BUSINESS CYCLE leading indicators to their highest level since July 2014.

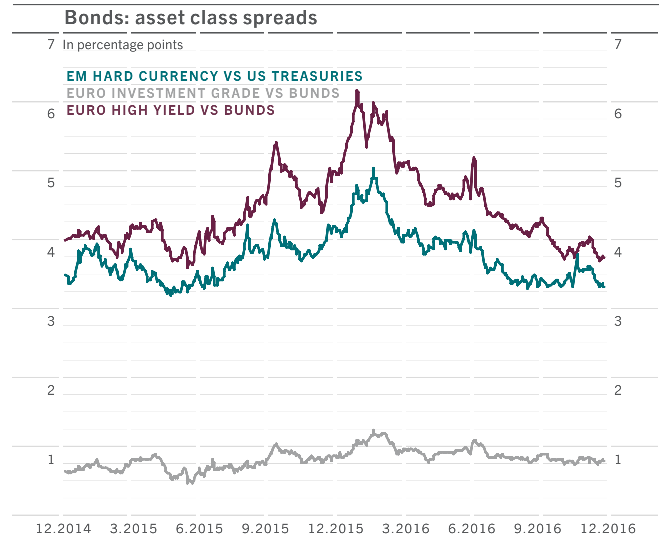
Leading the pack is the US, where consumption, housing markets and manufacturing activity were strengthening even before Trump swept to victory promising to boost growth through tax cuts, public spending and deregulation.

According to our analysis, Trump's fiscal policy should offset negative shocks to growth from a combination of higher bond yields, a strong US dollar and higher oil prices in 2017. We expect the Fed to deliver two more interest rate hikes this year, and expect the pace of tightening to pick up in 2018 – we think Trump's policies should contribute a net 0.4 percentage points to growth and raise price pressures.

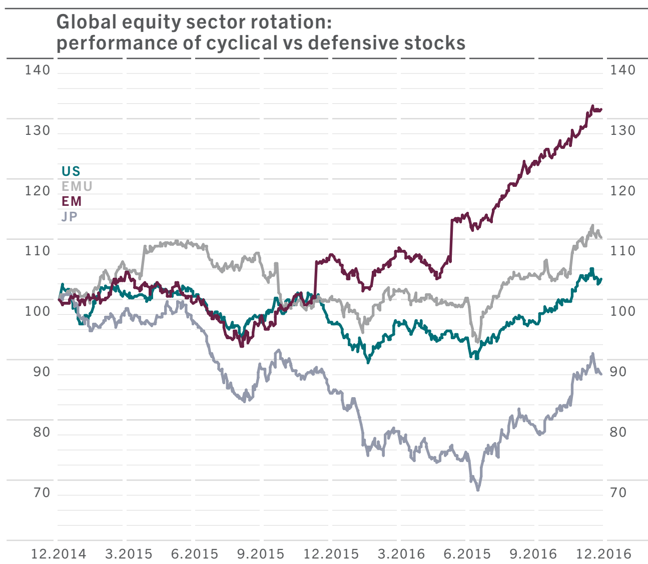
We are becoming more confident on the euro zone's growth prospects thanks to easy monetary policy and a weak euro, which should boost exports. Consumption remains the main engine of growth, underpinned by better labour market conditions, while manufacturing is also faring well, with the PMI hitting the highest since April 2011.

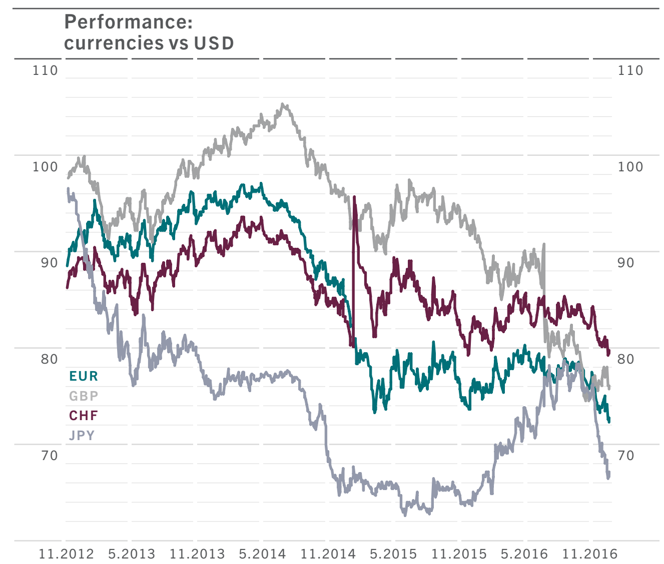
Major asset classes





Equity sector rotation and currency performance



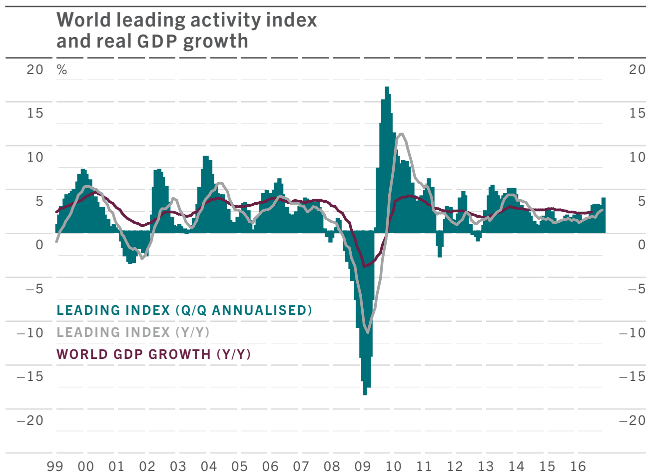


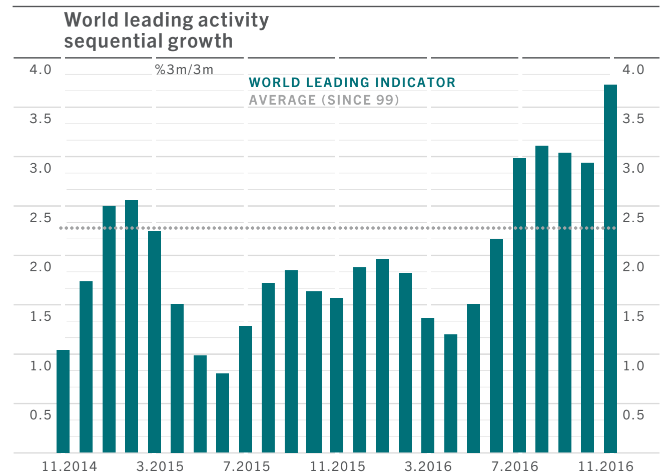
Source: Pictet Asset Management,
Thomson Reuters Datastream / JPM and BoA Merrill Lynch

Risk bias indicators

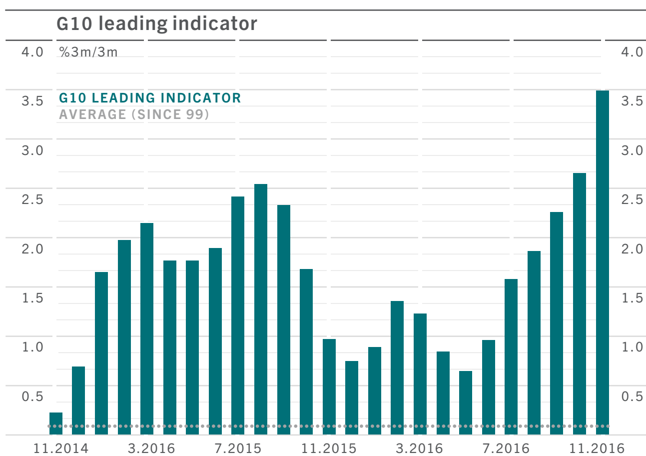
RISK BIAS INDICATORS	UNDERWEIGHT –		NEUTRAL 0		OVERWEIGHT +	MONTHLY CHANGE <<<<	>>>>
				Business cycle			>
		Liquidity					
			Valuation				
			Technicals				
			PAM Strategy				

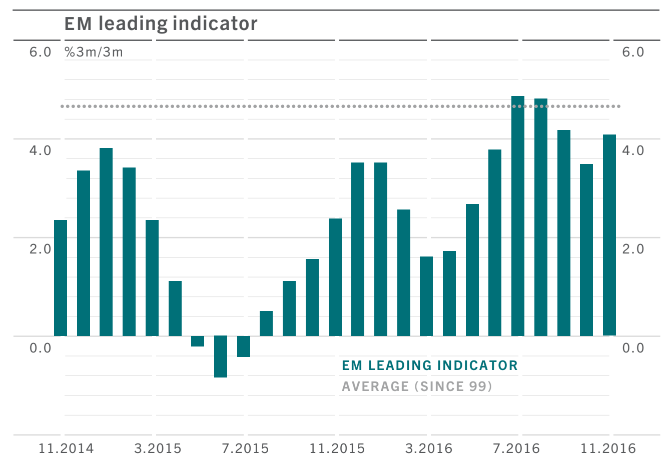
Business cycle: World economic growth continues to build





G10 economic momentum improving





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

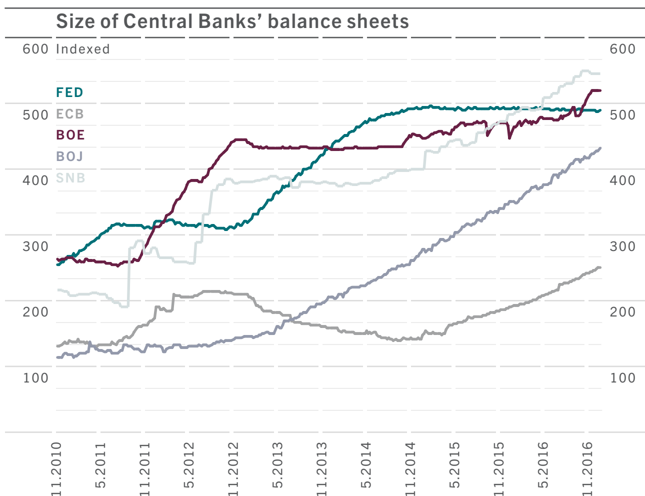
Valuation:
Equity markets and sectors

Countries and sectors

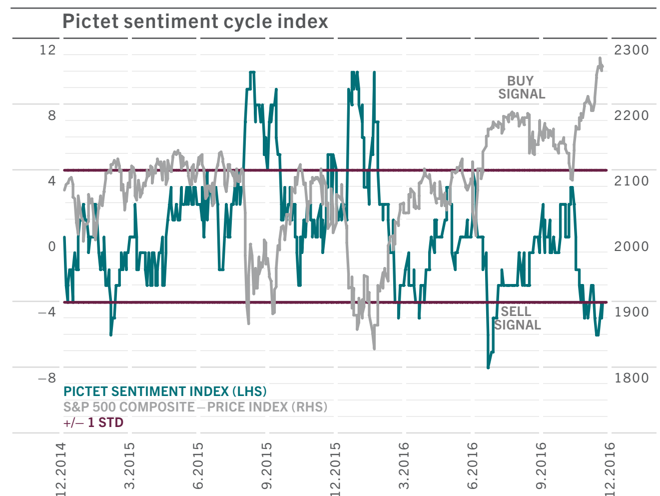
MSCI REGIONS	EPS GROWTH 2016	EPS GROWTH 2017	SALES GROWTH 2016	SALES GROWTH 2017	PE 2016	PE 2017	PB 2016E	P/SALES 2016E	DY 2016E
US	1%	12%	2%	6%	19.4	17.3	2.9	2.0	2.0%
EUROPE	-2%	14%	-2%	6%	16.5	14.5	1.7	1.2	3.6%
EMU	1%	12%	-1%	4%	16.1	14.3	1.6	1.0	3.3%
SWITZERLAND	-4%	9%	0%	3%	18.6	17.0	2.4	2.2	3.3%
UK	-4%	20%	-2%	9%	17.5	14.5	1.8	1.3	4.0%
JAPAN	12%	10%	-4%	3%	16.5	15.3	1.4	0.9	2.0%
EM	8%	13%	2%	9%	13.1	11.7	1.5	0.8	2.6%
ASIA EX-JAPAN	2%	13%	2%	9%	13.6	12.1	1.4	0.8	2.6%
GLOBAL	**2%**	**13%**	**0%**	**6%**	**17.6**	**15.6**	**2.1**	**1.4**	**2.5%**

MSCI SECTORS	EPS GROWTH 2016	EPS GROWTH 2017	SALES GROWTH 2016	SALES GROWTH 2017	PE 2016	PE 2017	PB 2016E	P/SALES 2016E	DY 2016E
ENERGY	-42%	101%	-12%	20%	41.7	20.7	1.5	1.0	3.3%
MATERIALS	15%	21%	-6%	7%	18.7	15.5	1.8	1.1	2.2%
INDUSTRIALS	8%	9%	0%	3%	18.4	16.9	2.6	1.1	2.3%
CONSUMER DISCRETIONARY	9%	12%	4%	5%	18.0	16.2	2.7	1.1	1.9%
CONSUMER STAPLES	5%	10%	4%	5%	21.0	19.0	3.9	1.3	2.7%
HEALTH CARE	7%	8%	7%	5%	16.3	15.1	3.4	1.8	2.1%
FINANCIALS	-3%	9%	3%	3%	13.2	12.1	1.2	1.6	3.0%
IT	4%	14%	1%	6%	19.0	16.6	3.5	2.5	1.5%
TELECOMS	9%	5%	4%	2%	15.3	14.6	2.2	1.3	4.1%
UTILITIES	-1%	1%	-8%	2%	14.9	14.7	1.5	1.1	3.9%

Liquidity: Central bank stimulus easing at the margin



Sentiment indicator shifts towards 'sell' signal



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

Japan's leading indicator is also gaining momentum as a weaker Japanese yen supports the country's export-dependent manufacturing sector. A tighter job market should meanwhile underpin consumer spending growth.

In contrast, we're more cautious on China, where policymakers are tightening the monetary reins in a bid to clamp down on the growth of opaque wealth management products. Moreover, accelerating capital outflows put downward pressure on the yuan, which increases the cost of servicing dollar-denominated debt held by Chinese companies and banks.

On a bright note, China and other emerging economies should benefit from higher commodity prices and improving trade on the back of rising demand from developed economies.

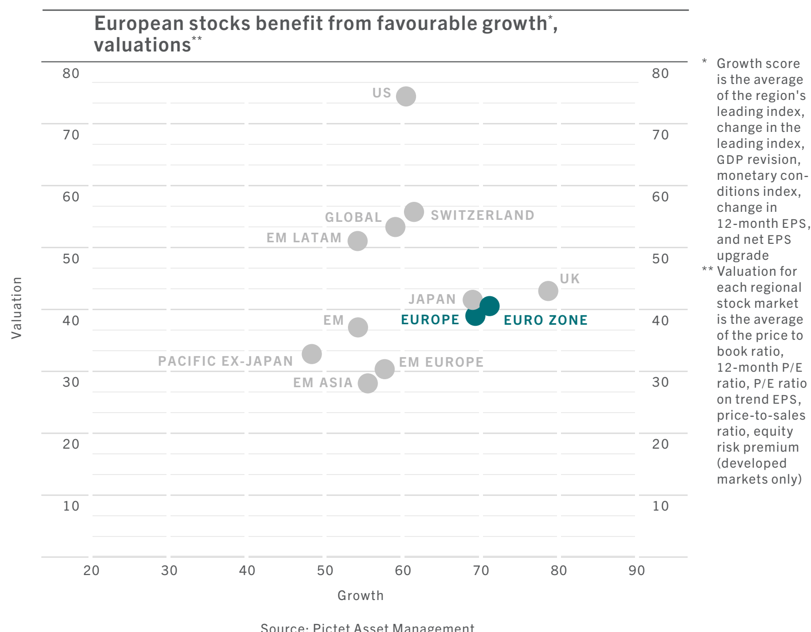
Our analysis of LIQUIDITY conditions suggests that riskier asset classes are vulnerable to a sell-off in early 2017. Central bank stimulus – in the form of bond purchases from the world's five major central banks – will decline this year compared to last year, falling to USD800 billion from US1.7 trillion.[1] Given the strong positive relationship between central bank stimulus and stocks' price-earnings ratios, this liquidity drain could compress equity valuations. Moreover, growth in commercial bank lending in major economies is slowing, weighing on credit conditions.

Our VALUATION gauges indicate that equity markets' recent strong run has taken stock valuations to mildly expensive levels, although with some regional differences. Measured by their price-earnings ratios, US equities are close to trading at their most expensive levels ever compared to both their European and Japanese counterparts. The equity risk premium over bonds has also narrowed in favour of bonds in all regions, but particularly in the US. More positively, however, our analysis suggests that, provided the world economy grows in line with our expectations for 2017, corporate earnings among US and European companies could rise at a faster pace than the 12 per cent analysts are forecasting. They could feasibly rise at a 15 per cent clip.

Separately, our TECHNICAL indicators are mildly positive for equities and neutral for bonds. That said, January has historically been a bad month for bonds. Our readings provide clearer signals for the US dollar, however, showing the currency should build on its recent appreciation – at least in the short term.

1 Central bank liquidity is the sum of asset purchases and credit operations net of sterilisation for the Fed, ECB, BOE, BOJ and PBoC.

Europe's turn to shine



* Growth score is the average of the region's leading index, change in the leading index, GDP revision, monetary conditions index, change in 12-month EPS, and net EPS upgrade

** Valuation for each regional stock market is the average of the price to book ratio, 12-month P/E ratio, P/E ratio on trend EPS, price-to-sales ratio, equity risk premium (developed markets only)

Source: Pictet Asset Management

It is time for European equities to come out of the shadows. Economic prospects are looking healthier than they have done for nearly two years.[2] The euro's exchange rate is competitive and monetary policy should remain accommodative for the foreseeable future – even taking into account the modest scaling back of ECB's liquidity injections in the second half of the year. And in the short-term at least, the risk of further political upheaval is low. Corporate earnings growth is forecast to rebound to a healthy double-digit rate from a nearly flat performance in 2016. Valuations are still favourable. Indeed, the discount offered by European stocks over their US peers has been deeper than the current level only 2 per cent of the time in the past 20 years.

Taking all this into account, we believe there is a strong case to upgrade European equities to overweight from neutral.

Based on the combination of relatively cheap valuations and the strong potential for growth, Europe is one of the most attractive equity regions globally (see chart). This same metric also supports our positive views on the UK and Japan. Although our technical indicators suggest Japanese stocks are overbought, an improving domestic economy, a weak currency and global reflation should offer the market some strong support.

In contrast, we have turned more cautious on Pacific ex-Japan, a stance that reflects both the possibility of economic turbulence in China – where monetary conditions are tightening and where protectionist steps from the US could also cause pain – and a relatively weak leading indicator for Australia.

For US equities, the likely positive boost from Trump's promised infrastructure spending and corporate tax cuts could be largely offset this year by tighter Fed policy, a strong dollar (which is at its most expensive ever on our models) and stretched stock valuations. Indeed, the US equity risk premium – our own gauge for the extra return you can reasonably expect by investing in stocks over government bonds – has slumped to a 10-year low of 4.3 per cent – down sharply from 5.5 per cent before the US presidential election.[3]

Because we expect the world economy to enjoy a boost from Trump's policies, we believe there is scope for cyclical stocks to outperform more defensive sectors. To our existing overweight positions in consumer discretionary, financials and IT, we have now added energy stocks. This sector should benefit from continued cost cutting as well as from a rosier outlook for crude prices following oil producers' decision to cut oil supply.

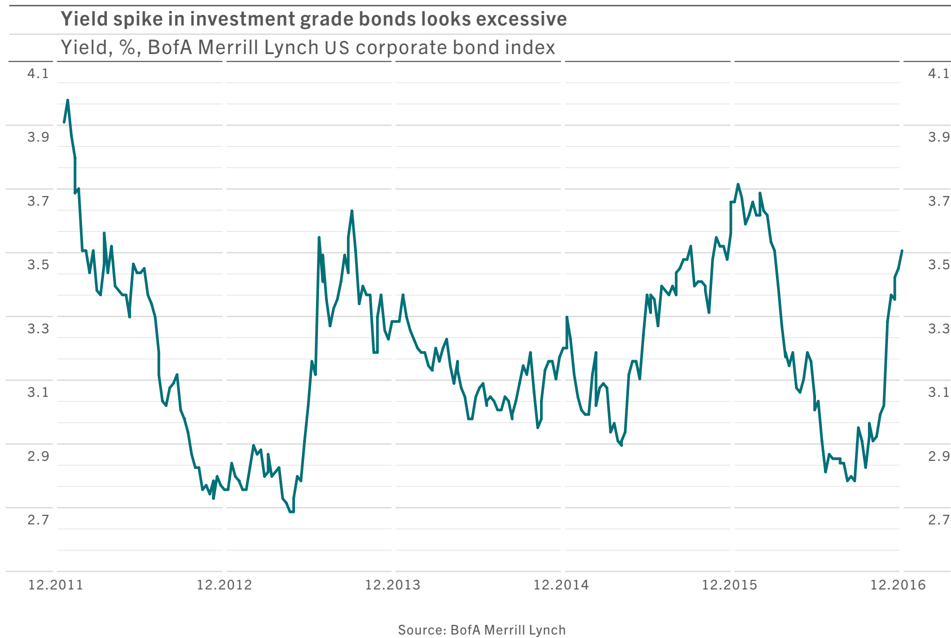
When it comes to industrial stocks, we believe that earnings expectations for the sector may have overrun in the "honeymoon period" following Trump's election. While his focus on infrastructure will undoubtedly be positive for many industrial companies in the long run, we are concerned that profit forecasts may already be too optimistic, at least in the short term. This, coupled with the fact that the recent rally has made industrials the most expensive sector in our scorecard, has prompted us to close our overweight position there.

The big risk for this year is Trump's impact on global trade. While he has pledged to impose import tariffs, we believe the plans will be both watered down and targeted at particular sectors and trading partners; the fallout should therefore be limited.

2 Based on Pictet Asset Management's leading indicators.

3 The equity risk premium is estimated using a discounted cash flow model based on consensus (IBES) EPS growth forecasts covering the next five years and our own forecasts for nominal GDP growth over the next decade. The model also assumes an average dividend payout ratio of 45 per cent.

A bond market rebound if risk sentiment flips from –on to –off



Source: BofA Merrill Lynch

The bond market shakeout since Trump's election victory has opened up some value, particularly in US bonds and not least in US investment grade credit, which we have upgraded one notch to overweight.

Investors appear to have priced in expectations that Trump will be able to implement much if not all of his promised tax and spending proposals. Ultimately, this would feed into stronger US growth and thereafter into the global economy. This, in turn, would feed into inflation, particularly as the US economy already appears to be close to full employment.

The degree of investors' economic bullishness, however, raises the risk of growth undershooting expectations. Indeed, political realities could well force Trump to wind back some of his proposals. At the same time several external factors are lining up against the US economy in the near term. In recent years, first quarter growth has tended to be weak and there are reasons to believe this will also be true of 2017. Global and particularly US liquidity conditions are turning negative, which could prove detrimental for equities. All of these factors suggest the prospect of a sudden flight from risk during the coming month or so, which could benefit US bonds, not least because the asset class is the most oversold it has ever been according to our indicators. Our preference is for the ultra-long end of the US bond yield curve; we remain underweight the short end which will continue to be sensitive to expectations of rising Fed funds rates.

US investment grade credit is likely to benefit in particular from expectations of a friendlier regulatory and tax regime under Trump and from an improved outlook for corporate earnings. This is why we have upgraded it to the same level as US high yield, which we've kept on a moderate overweight. Any moves by the Trump administration and Congress to end the tax deductibility of debt interest would be a further boost to the credit market, as it would reduce companies' incentive to issue debt, reducing the supply of bonds.

At the same time, we have trimmed our exposure to local currency emerging market debt one notch to underweight due to a combination of factors. First, we don't see dollar strength reversing in the immediate future, which is likely to weigh on emerging market currencies. Second, any flight from risk that ought to support US debt instruments is likely to be negative for emerging markets, with developing world central banks potentially forced to raise rates to fight any currency weakness. Third, flows out of China, driven in part by tighter US policy, has caused a sharp tightening of conditions in the Chinese debt market. Unless the People's Bank of China eases short-term rates in the near future, Chinese bond losses could continue for some time yet. And finally, even if Trump ignites strong US growth, there's a risk it won't flow to the rest of the world if he also implements an anti-trade agenda.

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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

Fair value models incorporate equity risk premium, historical earnings multiples

TECHNICALS

Pictet sentiment index (investors’ surveys, tactical indicators, flows data and momentum indicators)

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