PICTET
1805
Asset Management

MONTHLY
INVESTOR OUTLOOK ON
A 3 MONTH VIEW

January 2016

BAROMETER

Fed clears path for stocks to rally

GLOBAL ASSET CLASSES

We raise equities to overweight as we expect economic growth and corporate profitability to improve thanks to a rise in consumer spending and loose monetary conditions outside the US.

EQUITY REGIONS AND STYLES

Japan and Europe remain ourfavoured stock markets in the developed world and we upgrade emerging markets to overweight.

EQUITY SECTORS

Our cyclical tilt has been reinforced with the upgrade of consumer discretionary stocks to overweight.

FIXED INCOME

The risk-return profile of US high-yield debt and emerging market local currency debt has improved. We therefore upgrade both to overweight.

	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				

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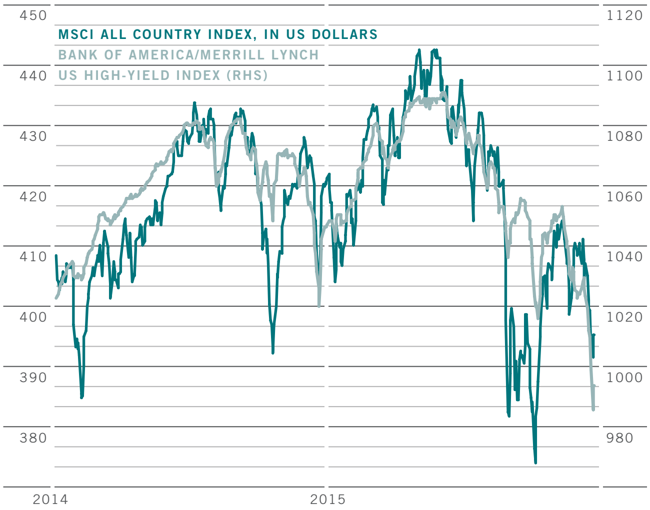
Equities underperform bonds; oil skids

HIGH-YIELD BONDS AND STOCKS SUFFER AS 2015 DRAWS TO A CLOSE



Source: Thomson Reuters Datastream

Global equities underperformed bonds in December as a sharp decline in oil prices weighed on the energy and materials sectors. Stock markets briefly rallied but then fell back after the US Federal Reserve delivered the first rate hike in almost a decade.

In a highly symbolic move, the US central bank ended its crisis-era policy by raising rates by 25 basis points. It promised it would proceed slowly with further tightening while monitoring inflation, which remains below target.

Emerging market stocks and bonds extended losses in the month, although the Fed's assurance of gradual rate rises stabilised the market somewhat. Emerging European stocks and local bonds were the worst performers of the month.

Japanese stocks were in the red at the time of writing as investors were disappointed by a smaller-than-expected stimulus by the Bank of Japan, which said it would buy government bonds with longer maturities and purchase an extra JPY300 billion a year in equities.

In the euro zone, the European Central Bank cut its deposit rate and extended its government bond purchase programme by six months in an ongoing effort to bring inflation back up to its 2 per cent target. However, the latest move also fell short of market expectations, weighing on European shares. The euro hit a one-month high against the US dollar following the ECB's announcement.

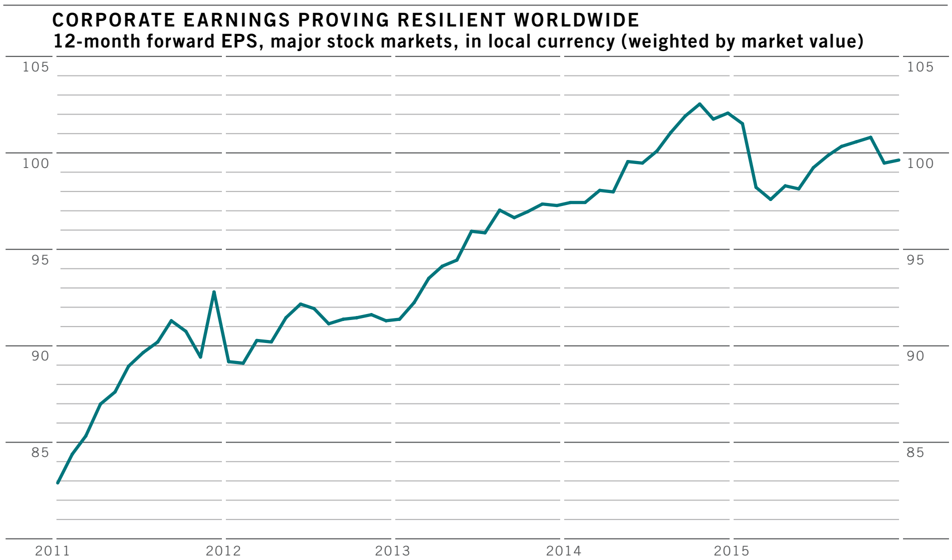
In fixed income, a monetary policy divergence between the US and Europe left its mark on government bond markets. With the yield on policy-sensitive two-year US Treasuries hitting 1 per cent, the highest since April 2010, the yield spread between two-year US and German government bonds traded at around 134 basis points, near a high last seen in 2006.

Another market that has seen turmoil of late is US high yield bonds, which are seen as vulnerable to higher interest rates. The market fell more than 3 per cent in the first two weeks of the month after a shock liquidation of a junk bond fund triggered broad selling before regaining some poise. At one point the benchmark yield for junk bonds hit 9 per cent, a level not seen as since the financial crisis.

Elsewhere, a stronger US dollar weighed further on commodity prices, which were already under pressure from oversupply concerns. Brent oil hit a seven-year low below USD37 a barrel, extending this year's losses to more than 45 per cent. Gold briefly hit the lowest level since February 2010.

* Market review as of 18.12.2015

Raise exposure to stocks as Fed move eliminates some uncertainty



Source: Thomson Reuters Datastream

The Fed's decision to raise interest rates for the first time in almost a decade does not in itself bring the curtain down on an era of ultra-loose monetary policy. Nor should it prevent stocks from moving higher over the coming months.

The US central bank's insistence that it will tighten the monetary reins gently and the growing prospect of additional stimulus elsewhere have encouraged us to raise our exposure to equities. Our move is also a response to a recent fall in stock valuations and what we believe is an excessive decline in market expectations for corporate profit growth next year. We retain our underweight stance on bonds as we expect inflationary pressures to rise.

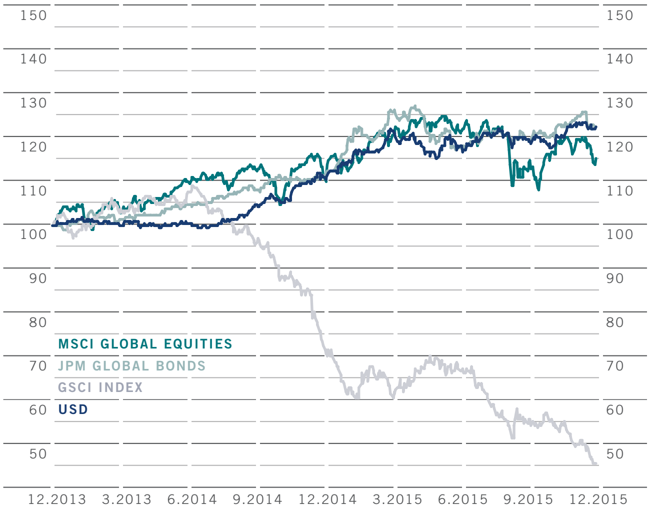
The Fed's historic rate rise was accompanied by a statement signalling policymakers would tighten monetary policy at a "gradual" pace as well as a slight reduction in the central bank's projected interest rate trajectory through to 2018.

Although the gap in the Fed's own interest rate expectations and those of the market remains wide – the central bank pencils in four hikes for 2016, the market only two – we believe the economy will be in good enough health to withstand further tightening in US monetary policy. There are two reasons for our optimism. The first is the Fed's stance. It is clear from its statement that the pace of interest rate hikes will depend on inflation and conditions in the labour market. Any slowdown in job or earnings growth is – in our view - sure to make policymakers think very carefully before raising rates again. In another dovish development, the Fed said it would not halt the re-investment of proceeds from bond sales until the normalisation of interest rates "was well under way".

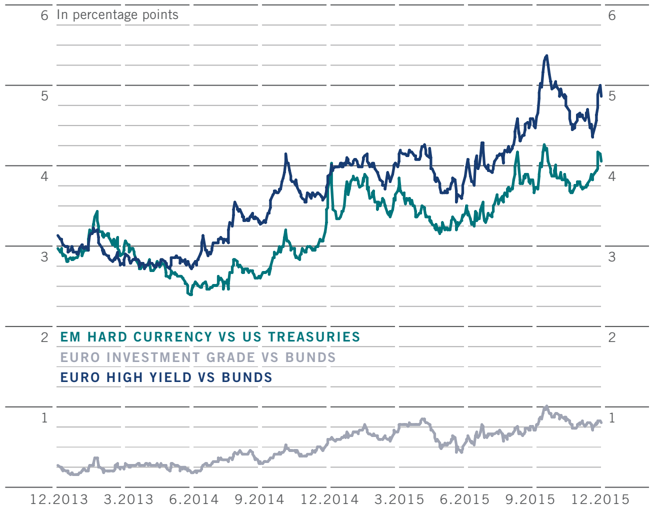
A second reason to be optimistic about global growth is that monetary stimulus in the euro zone and Asia is set to eclipse the withdrawal of liquidity that is bound to unfold in the US. Although the Fed will at some point begin draining liquidity from the financial system, 2016 will continue to see liquidity expand worldwide. By our calculations, the actions of the European Central Bank, the Bank of Japan, the People's Bank of China and the Bank of England, will result in a net expansion of liquidity equivalent to USD1 trillion.

Major asset classes

PERFORMANCE: ASSET CLASSES

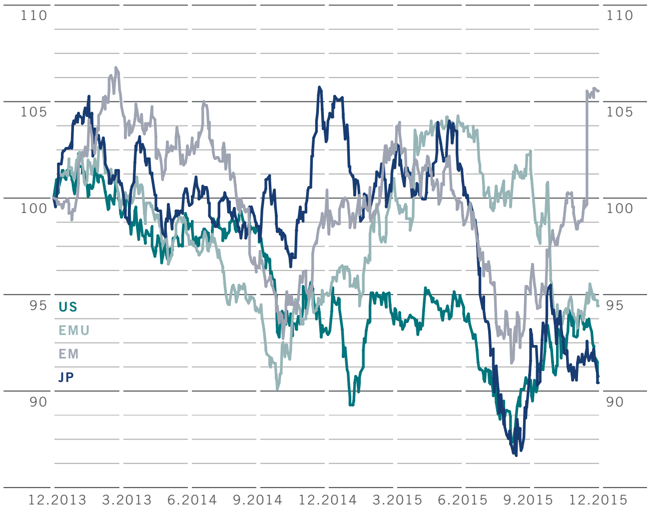


BONDS: ASSET CLASS SPREADS

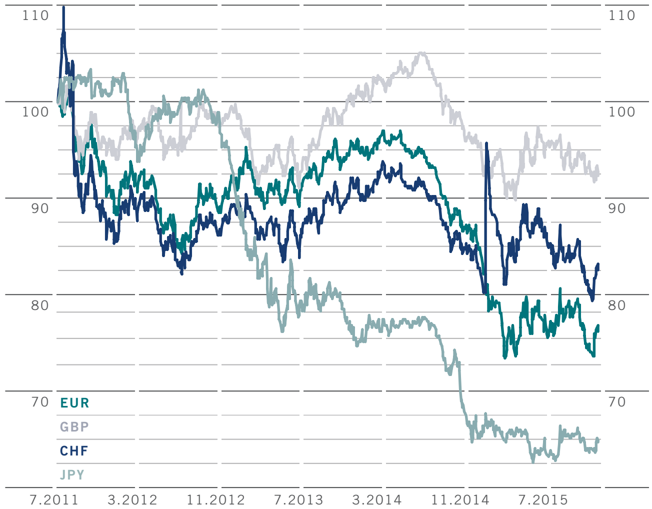


Equity sector rotation and currency performance

GLOBAL EQUITY SECTOR ROTATION: PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS



PERFORMANCE: CURRENCIES VS USD



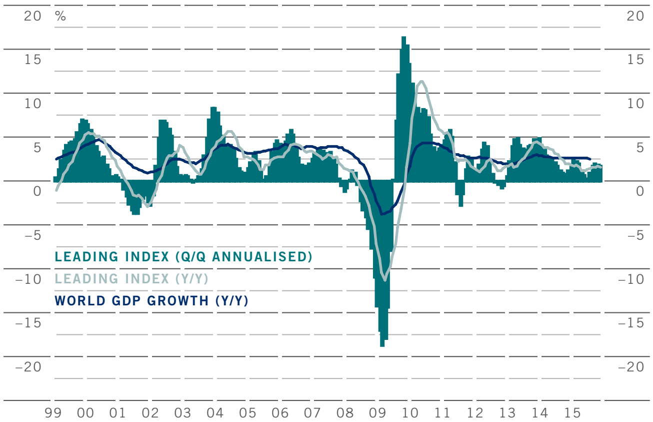
Source: Pictet Asset Management,
Thomson Reuters Datastream / JPM and BoA Merrill Lynch

Risk bias indicators

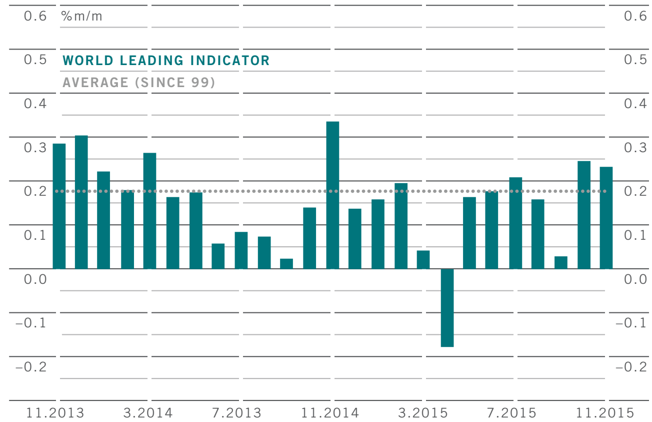
RISK BIAS INDICATORS	RISK OFF —	NEUTRAL 0	RISK-ON +	MONTHLY CHANGE <	>
Business cycle					>
Liquidity					>
Valuation					>
Technicals					
PAM Strategy					>

Business cycle: World economic growth continues to build

WORLD LEADING ACTIVITY INDEX AND REAL GDP GROWTH

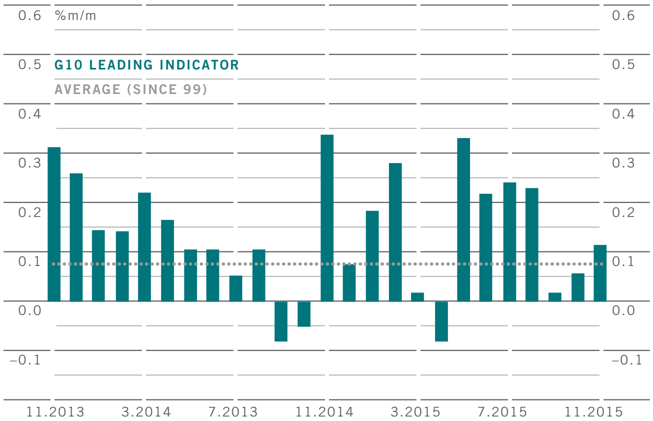


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH

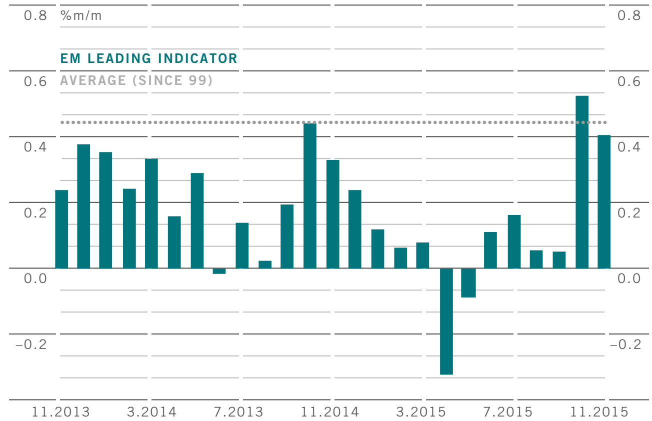


Economic momentum in G10 picks up further; emerging markets lag

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



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

Valuation: Equity markets and sectors

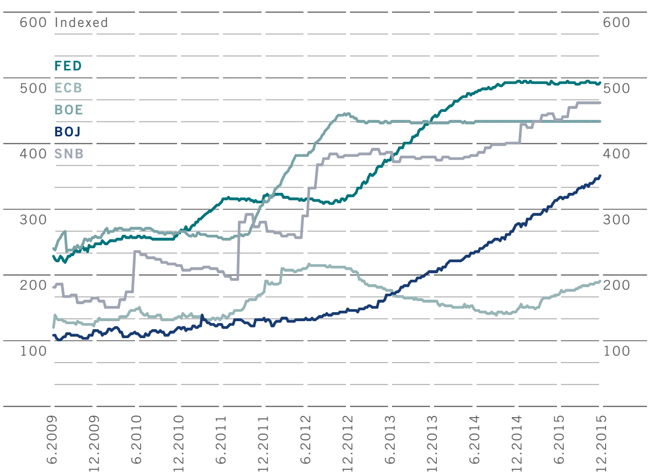
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
	2015	2016	2015	2016	2015	12M	2015E	2015E	2015E
US	1%	8%	-3%	4%	17.8	16.6	2.7	1.9	2.1%
EUROPE	-1%	7%	-3%	3%	16.0	15.1	1.8	1.2	3.5%
EMU	11%	8%	4%	3%	15.7	14.6	1.6	1.0	3.2%
SWITZERLAND	-6%	5%	-1%	3%	17.8	17.0	2.4	2.3	3.1%
UK	-15%	5%	-13%	2%	15.7	15.1	1.8	1.2	4.2%
JAPAN	19%	7%	1%	3%	15.4	14.7	1.4	0.9	1.9%
EM	-2%	9%	-1%	7%	12.1	11.2	1.4	0.7	3.0%
NJA	3%	8%	-1%	7%	12.3	11.5	1.3	0.7	2.9%
GLOBAL	**0%**	**8%**	**-2%**	**4%**	**16.7**	**15.5**	**2.0**	**1.4**	**2.6%**

MSCI GLOBAL SECTORS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
	2015	2016	2015	2016	2015	12M	2015E	2015E	2015E
ENERGY	-50%	5%	-27%	3%	20.0	19.1	1.3	0.8	3.9%
MATERIALS	-17%	11%	-7%	1%	17.1	15.5	1.5	0.9	3.0%
INDUSTRIALS	3%	9%	1%	4%	17.4	16.2	2.5	1.0	2.3%
CONSUMER DISCRETIONARY	12%	14%	6%	6%	18.7	16.6	2.9	1.2	1.9%
CONSUMER STAPLES	-1%	7%	1%	4%	21.9	20.5	4.0	1.3	2.6%
HEALTH CARE	10%	9%	8%	8%	18.8	17.3	3.9	2.1	1.8%
FINANCIALS	11%	6%	5%	5%	12.7	12.0	1.2	1.7	3.2%
IT	5%	8%	3%	4%	17.9	16.5	3.1	2.3	1.6%
TELECOMS	8%	6%	4%	4%	15.7	14.9	2.2	1.3	4.2%
UTILITIES	9%	-3%	-1%	1%	13.8	14.1	1.4	0.9	4.0%
MARKET	0%	8%	-2%	4%	16.7	15.5	2.0	1.4	2.6%

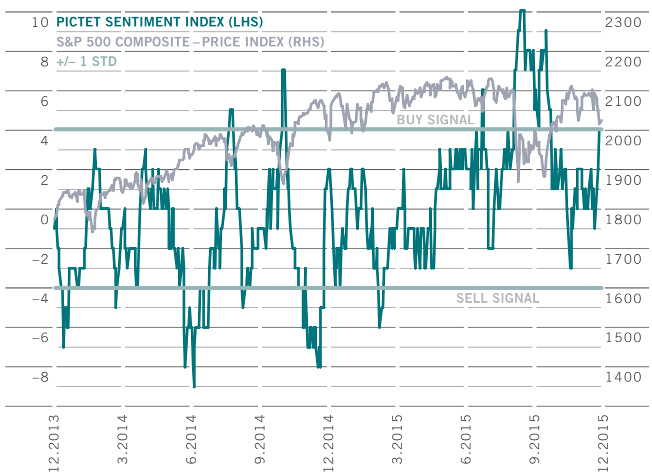
Liquidity: Fed ends QE and raises rates, but monetary stimulus continues elsewhere

SIZE OF CENTRAL BANKS' BALANCE SHEETS



Sentiment indicator close to 'buy' signal

PICTET SENTIMENT CYCLE INDEX



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

Our **BUSINESS CYCLE** readings point to steady growth in the developing world and a modest improvement in economic conditions in emerging markets. In the US, we expect to see consumer spending increase over the next six months, thanks in part to a further decline in household energy bills. This should more than offset the weakness of the US manufacturing sector, where the export-dampening effect of a strong US dollar has pushed the ISM Manufacturing Index below 50. Aided by buoyant consumption, the US economy should grow comfortably above 2.5 per cent in 2016.

In the euro zone, meanwhile, economic activity remains robust, with an increase in bank lending to both companies and households likely to lift growth further over the coming months. Business sentiment surveys show that conditions in domestic and export-oriented manufacturing sectors are improving, which suggest industrial production could rebound.

Economic momentum appears to be building most rapidly in emerging markets. Not only have our leading indicators improved every month since June, but the emerging market economic surprises index – a gauge measuring the extent to which data surpasses or undershoots consensus forecasts – has risen to its most positive level in more than a year. What is more, compared to the developed world, the index reading is at its highest since 2012.

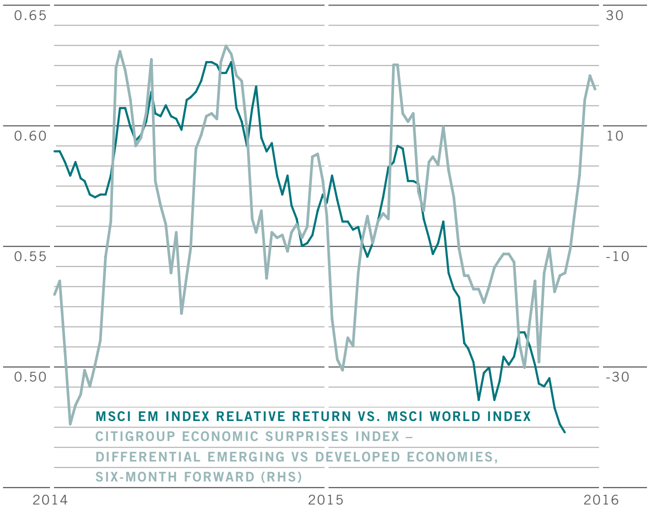
Our **LIQUIDITY** readings continue to show that monetary conditions in the US are deteriorating but improving elsewhere. The euro zone is enjoying an annualised 6 per cent increase in its money supply. Monetary conditions are also buoyant in Japan and are improving considerably in China.

Our **TECHNICALS** indicators are most positive for emerging markets, where investor positioning has been excessively bearish for some time.

When it comes to **VALUATIONS**, equities remain inexpensive relative to bonds. The bond-stock valuation gap is especially wide in the euro zone – particularly in Germany. The US, by contrast, is one of the few markets where there is little to choose between bonds and stocks. Indeed, with US corporate bond spreads having widened in recent months, US high-yield debt offers better value than equities. The US equity market looks especially expensive when compared to corporate profit trends. The US is in the midst of a profit recession – the third quarter earnings season revealed an aggregate drop in operating profits, the first decline since 2009.

Raising exposure to emerging markets, materials and consumer discretionary

EM STOCKS COULD RECOVER AS ECONOMIC CONDITIONS IMPROVE



Source: Thomson Reuters Datastream, Citigroup, Pictet Asset Management

In our regional allocation, we raise emerging market equities to overweight as valuations for the asset class have become more attractive thanks to a stabilisation of economic conditions across the developing world.

We continue to like the euro zone and Japan, where stocks are relatively inexpensive and exceptionally supportive monetary policies are set to continue.

Our upgrade of emerging market equities is a reflection of improving economic momentum, which sets the stage for a recovery in the earnings of emerging corporates (see chart). Our proprietary leading indicators have improved for the fourth consecutive month, suggesting that the region's economies are stabilising. Economic momentum is strongest in China, which has seen a moderate recovery in its industrial sector, fuelled by credit growth and a slight improvement in exports. There are signs that this economic strength is filtering through to other parts of emerging Asia. Another strong support is Chinese monetary policy which is the most expansionary it has been in years.

This improving outlook for growth comes at a time when both valuations for – and investor positioning in – emerging equities reflect an excessive level of pessimism. With the pace of corporate earnings forecast cuts having slowed in recent months, we believe the stage is set for an end to the four-year decline in company profits. And with expectations for profit growth now at their lowest levels in years, emerging market stocks have the potential to surprise, in our view.

The euro zone remains among our favourite equity markets because of improving prospects for corporate earnings in the region. A combination of accommodative monetary policy and economic resilience are creating the backdrop for profits to recover, with the weak euro and low oil price acting as strong tailwinds boosting exports and household spending power. Valuations for European stocks are also the most attractive among developed markets, both compared to bonds and on the basis of normalised corporate earnings. What is more, euro zone equities are trading at their lowest ever level relative to their US peers in US dollar terms.

Japanese equities are another bright spot. Japanese stocks are on course to deliver gains of some 7 per cent this year in US dollar terms, and there is scope for the market to add to those returns.

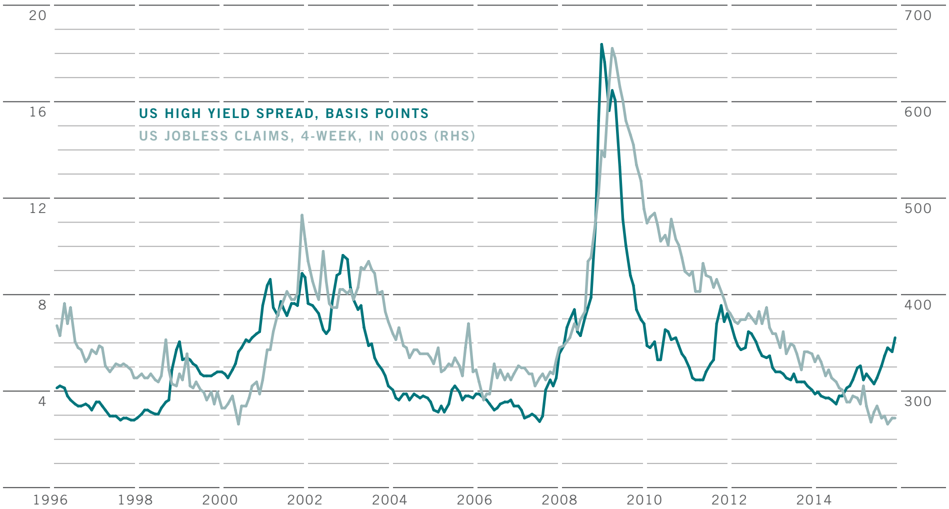
Like their European peers, Japanese companies have seen their global competitiveness boosted by a currency effect – an advantage which is set to endure as the BoJ pursues its massive quantitative easing programme to achieve its inflation target. Recent revisions to third quarter data showed the economy did not go into contraction as feared. Official figures instead show modest growth as capital spending and factory output picked up. At the same time, new corporate governance reforms are pushing Japanese companies to unlock their corporate coffers and make better use of their balance sheets – a structural change which holds out the prospect of a steady increase in the market's return on equity.

In the US meanwhile, the third quarter earnings season ended on a subdued note, with 65 per cent of companies beating already low expectations. Average operating earnings contracted 0.7 percent. Our forecast is for another quarter of earnings declines before a recovery. Higher interest rates, and slowing economic momentum will also make conditions more challenging for US companies to outperform their peers elsewhere in the developed world.

In our sector allocation, we reinforce our cyclical tilt with an upgrade of materials and consumer discretionary, and take some profit on technology stocks. Materials are upgraded on account of the recent economic stabilisation in China and emerging markets. Supply cutbacks by miners such as Anglo American mean capacity has been greatly reduced, while sharp falls in the sector have left stocks trading at attractive multiples. Meanwhile, consumer discretionary stocks are raised to overweight because they stand to benefit from households' increased purchasing power as a result of the fall in the oil price.

High yield attractive in a world of negative yields

HIGH YIELD SELL-OFF AT ODDS WITH IMPROVING ECONOMIC CONDITIONS



Source Thomson Reuters Datastream

The build-up to the December rate rise from the Fed saw the US dollar push higher, causing more pain to emerging market bonds and currencies as 2016 drew to a close. However, we now feel that these markets will soon come to appreciate the fact that monetary tightening in the US will be gradual and modest. What is more, our leading indicators suggest that economic conditions in the emerging world, particularly in Asia, are beginning to improve.

Consequently, we believe the US dollar's appreciation is likely to slow in the coming months, easing the strain on emerging market fixed income and currencies. The US currency is some 30 per cent overvalued on a trade-weighted basis, according to our model.

With this in mind, we have opted to increase our exposure to local currency emerging market bonds, which is one of the cheapest asset classes on our valuation scorecard. Yields on local currency debt are at 7.2 per cent in aggregate – the highest level since 2010. What is more, emerging currencies are trading at levels that are three standard deviations below what we consider to be fair value.

There are, of course, some risks for emerging bond markets, notably the possibility of a hard landing in China and the potential – however small – of a heavy-handed monetary tightening in the US. Under this scenario, some of the more financialy-stretched emerging borrowers could come under pressure. Still, we generally expect emerging currencies to end their protracted declines and anticipate a pickup in export demand to boost Asian economies. We also envisage some fiscal and monetary stimulus from China at some point in early 2016, which would further underpin the prospects for emerging market fixed income.

Elsewhere, in developed markets, the recent spike in yields on US high-yield bonds looks unjustified on many fronts; we consequently raise our exposure to the market to overweight.

The risk premium for high yield debt is above the long-term average. That is in stark contrast to developed world government and investment grade bonds, where risk premia are either at or below the long term trend.

The asset class also looks cheap on other measures. With spreads on US high yield bonds having widened to more than 700 basis points on an options-adjusted basis – more than double the low hit in 2014 – the implied bond default rate has spiked to 11 per cent, a level usually associated with recession.

This anomaly is illustrated in the chart, which shows US high yield bond spreads have widened even as the US jobs market has improved. Furthermore, given the gradualist and cautious approach emphasised by the Fed, a spike in defaults from high yield borrowers is unlikely.

Elsewhere, we shift overweight the euro versus the US dollar. Not only do we believe the single currency region's improving economic prospects could serve as a magnet for investment flows, but we also feel that the scope for a further gain in the US dollar is limited due to its historically high valuation and overly-bullish investor positioning in the US unit.

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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

Equity risk premium, yield gap, historical earnings multiples

SENTIMENT

Pictet sentiment index (investors' surveys, tactical indicators)

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