PICTET
1805
Asset Management

FOR PROFESSIONAL INVESTORS ONLY

# ANNUAL OUTLOOK

## The investment landscape in 2017

### GLOBAL ASSET CLASSES

Rising inflation and tightening monetary policy will prove tough for bonds in 2017, while cyclically-sensitive equity sectors should benefit from improving economic growth.

### EQUITY REGIONS AND STYLES

Japanese equities rate strongly both on valuations and fundamentals. Selected emerging markets could also do well.

### FIXED INCOME

Inflation-linked bonds are starting to look attractive again, while high yield bonds (particularly in the US) merit a more cautious approach.

**THE PICTET ASSET MANAGEMENT STRATEGY UNIT (PSU)**

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

# Beware the flames of inflation

Economic and earnings forecasts for 2017, %

| | GDP GROWTH | | INFLATION | | EARNINGS GROWTH (CONSENSUS) | |
|---|---|---|---|---|---|---|
| | 2016 | 2017 | 2016 | 2017 | 2016 | 2017 |
| US | 1.5 | 2.3 | 1.2 | 2.5 | 0.6 | 12.9 |
| EURO-AREA | 1.6 | 1.4 | 0.2 | 1.1 | 0.7 | 12.8 |
| UK | 2.0 | 0.4 | 0.6 | 2.5 | -5.7 | 16.8 |
| SWITZERLAND | 1.5 | 1.6 | -0.4 | 0.8 | -3.7 | 9.9 |
| JAPAN | 0.8 | 1.2 | -0.3 | 0.7 | 11.9 | 8.1 |
| CHINA | 6.6 | 6.3 | 2 | 2.2 | -0.1 | 15.3 |
| EMERGING MARKETS | 4.1 | 4.4 | 3.7 | 3.7 | 7.0 | 13.2 |
| GLOBAL | **2.6** | **2.9** | **1.9** | **2.6** | **1.4** | **12.9** |

Source: Pictet Asset Management, CEIC, Thomson Reuters Datastream. As at 16.11.2016

Winter is coming. But as temperatures fall across the Northern hemisphere, in the financial arena one element is heating up – inflation.

From the US in the West to China and Japan in the East, we see price pressures accelerating next year in virtually every major economy, with global inflation hitting a four-year high. In the US, Donald Trump's victory in the presidential elections is likely to further stoke the fire as promises of extensive infrastructure spending and tax cuts pump billions of dollars into the economy and boost commodity prices.

In the UK, meanwhile, prices will be pushed up by the 12 per cent slump in sterling's trade-weighted exchange rate since the June referendum vote to leave the European Union.

The change in the investment climate will also be characterised by heightened geopolitical risks and a looming reversal of one of the most potent investor-friendly trends of recent years – ample liquidity.

Politically, the spotlight is now on continental Europe. Following the surprises of the Brexit vote and Trump's win, investors will be looking for any signs of similar anti-establishment feeling in Italy's constitutional referendum this December, as well as in the German general election and French presidential polls in 2017.

The liquidity path is, arguably, easier to predict. We now forecast three US Federal Reserve interest rate hikes by end-2017, starting this December. This is an increase from the previously expected two hikes as we think that Trump's fiscal loosening will be counteracted by tighter monetary policy.

In the euro zone, the European Central Bank's quantitative easing programme will almost certainly be extended beyond March, but we expect that liquidity injections will be reduced by the end of next year to EUR60 billion per month as inflation and growth pick up.

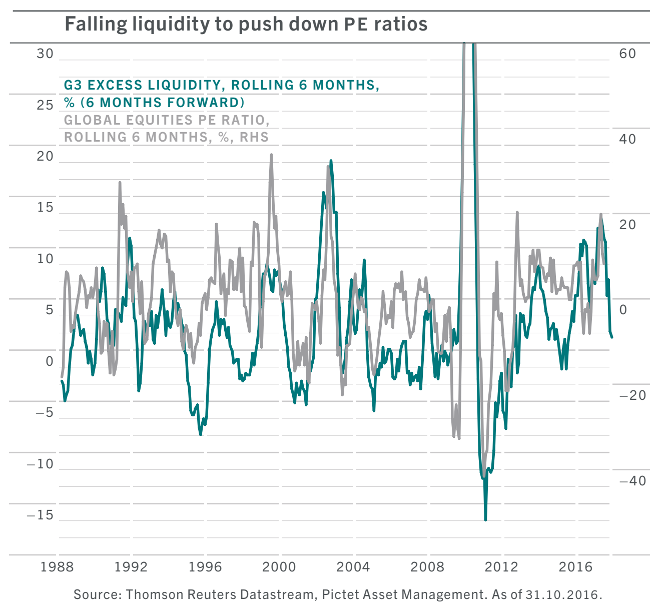
In total, we believe that between them the Fed, the ECB and their counterparts in the UK, China and Japan will generate USD900 billion of net liquidity in 2017 – an almost 50 per cent decline on this year's USD1.7 trillion and compared to an average of USD1.2 trillion per annum over the past seven years.[1]

More positively, global corporate earnings should benefit from an acceleration in nominal gross domestic product (GDP) growth and could rise by as much as 13 per cent globally compared with a paltry 1 per cent this year. Bigger profits, in turn, could encourage companies to step up capital expenditure, enabling business investment to surpass consumer spending as the main source of economic growth.

The broader economic recovery – while still relatively muted – is becoming increasingly widespread. Leading indicators and global business confidence are rising in all major economies and we see scope for positive surprises in the US, euro zone and Japan on the back of more expansionary fiscal policy.

1 Central bank liquidity is the sum of asset purchases and credit operations net of sterilisation operations. Source: Thomson Reuters Datastream, Pictet Asset Management

# Liquidity drain a risk for all asset classes




Source: Thomson Reuters Datastream, Pictet Asset Management. As of 31.10.2016.

Investors will need to buckle up in 2017. Political turmoil, rising inflation and tighter financing conditions look set to rub up against improving economic growth and rising corporate earnings. That adds up to a challenging environment for equities but potentially a pretty grim one for bonds and bond-like dividend-paying stocks.

For the US dollar, the path is more nuanced. Upward forces from Fed's rate hikes and Trump's economic stimulus are likely to triumph in the short-term, but over a longer time horizon they will be counteracted by the currency's increasingly stretched valuation and – potentially – by reduced foreign investor appetite for US assets.

The winners in the current climate should include cyclical shares as well as traditional hedges against volatility and inflation, such as gold, the VIX and inflation-linked bonds. We also think it is prudent to go into next year with ample holdings of cash – both as insurance against market falls and, arguably more importantly, to be ready to take advantage of any dislocations and mispricing that could follow from political upsets or policy actions.

US dollar **LIQUIDITY** – as measured by the US monetary base and foreign official assets denominated in US dollars held at the Fed – is already falling at a rate of 5 per cent year-on-year. The drain is likely to accelerate in 2017 thanks to more hikes from the Fed, continued falls in emerging market foreign currency reserves and reduced bond purchases by both the ECB and the Bank of Japan.

Historical correlation analysis suggests that lower liquidity will – with a six month lag – result in reduced earnings multiples (see chart).

That's not to say the picture is universally negative for equities. One support for riskier asset classes will be better economic growth. Our **BUSINESS CYCLE** indicators point to an accelerating – albeit still modest – economic expansion. The global manufacturing PMI has risen to a two-year high, to levels consistent with 3.5 per cent annualised growth in industrial production. Activity picked up in 22 out of the 31 countries included in the index, suggesting that the recovery is widespread.

Within the developed world, we have upgraded our growth forecast for the US economy. Trump's plans to slash corporate tax rates to 15 per cent from 35 per cent, spend at least an additional USD 500 billion on infrastructure and encourage multinationals to repatriate foreign earnings could add as much as 1 percentage point to GDP growth in the next two years (although the final policy mix is likely to be watered down significantly from the campaign promises). Fiscal easing will result in a longer economic cycle than we assumed a few months ago. The risk of a recession in the next 12-18 months now looks more remote, as long as private investment spending rises at a faster rate than GDP.

Growth-boosting fiscal policy is also on the cards in Europe and Japan. In the former, it will combine with pent-up demand, improving lending conditions and a competitive exchange rate.

In Japan, meanwhile, fiscal stimulus sits alongside rising exports, which have already helped annualised growth to smash expectations in the third quarter of 2016 with a 2.2 per cent reading versus consensus forecast of 0.8 per cent.

China is one of the few countries where we see growth easing next year, but only modestly. Protectionist policies from the US are a risk, but our base case scenario is that these are not imminent.

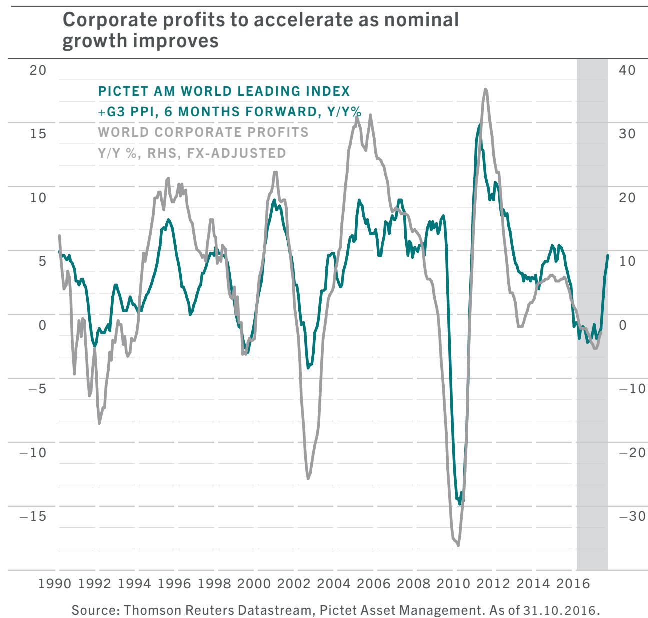
In terms of **VALUATIONS**, global equities look fairly valued at a 15.3 times the 12 month forward earnings. Bonds are still expensive but their recent sharp sell-off has cut the overvaluation by a third.

The equity risk premium (excess return over government bonds) is significantly above its 10-year average with the notable exception of the US. We would argue that this spread should remain wide, in line with elevated policy uncertainty.

* G3 broad money minus value of domestic industrial production growth over the past 6 months (GDP-weighted). Forecast assumes that G3 industrial production will continue to rise at the same pace of the last 3 months, PPI will rise in line with the oil price (with a lag) and money supply growth will be at the bottom quintile since 2009.

# Japan leads on valuation and prospects

**Corporate profits to accelerate as nominal growth improves**




Source: Thomson Reuters Datastream, Pictet Asset Management. As of 31.10.2016.

Bad news for equities includes tightening liquidity conditions, political upheaval and the return of wage inflation. The risk of protectionism is extremely difficult to price but even a low-intensity trade war stoked by the new US administration can do long-term damage to equities, especially for emerging markets and for large-cap companies with substantial global supply chains.

History also suggests a cautious positioning – the first year of a US presidential term has traditionally been the worst for equity markets. Election years, in contrast, have been some of the best.

Good news comes in the form of an expected acceleration in corporate earnings growth. Globally, we see companies posting double-digit profit growth in 2017 after a virtually flat showing in many key markets this year. A move by the US administration to cut regulation and corporate taxes could offer further support. If all the tax cuts proposed by Trump are implemented – which is not a given – they could boost US equity values by 7-10 per cent.

However, US stocks are close to being the most expensive ever versus Japanese and European peers so a marked further outperformance is unlikely unless markets enter a risk-off phase or the dollar depreciates markedly.

Europe, for example, is trading at a 24 per cent discount to the US based on the 12-month price-to-earnings (PE) ratios, compared with a 10-year average of 17 per cent.

That in itself, however, is not necessarily a reason to buy. While European equities could present an attractive investment opportunity in the medium term, for now there are good reasons for the hefty risk premium. The banking sector, where the potential for large scale recapitalisations is high, is one area of concern. An even bigger issue is regulation. In Europe more than elsewhere, domestic institutions, such as insurers, are restricted in their ability to sell bonds and buy equities. That means the impetus for a market rebound will need to come from foreign investors. This is unlikely to happen while there are still uncertainties over both ECB policy and the outcome of various European elections. By the second half of 2017, these risks may well have cleared, paving the way for a reversal in the extremely negative sentiment and thus for a market rally.

Japan, on the other hand, is worth buying now – not just because it is the cheapest developed stock market in our model but also because of its positive economic prospects. Although trade curbs are a risk in Japan, its exporters should win out as global growth improves. This will enable the Tokyo bourse to shrug off any negative implications of tighter global monetary policy and rising bond yields. Japan is also historically a market that benefits the most in a global reflation scenario.

Within Japan, some of the best opportunities can be found in financials. The gradual steeping of the Japanese bond yield curve may well boost banks' lending spreads (the difference between the rate they charge on loans and the one they offer on deposits), while the improving economic outlook bodes well for credit demand.

We are bullish on the long-term outlook for emerging markets due to their attractive valuations, structural reforms, a recovery in commodity prices and healthy investment flows. However, the recent sell-off highlights the vulnerability of this asset class to trade concerns, a surging dollar and tighter financial conditions.

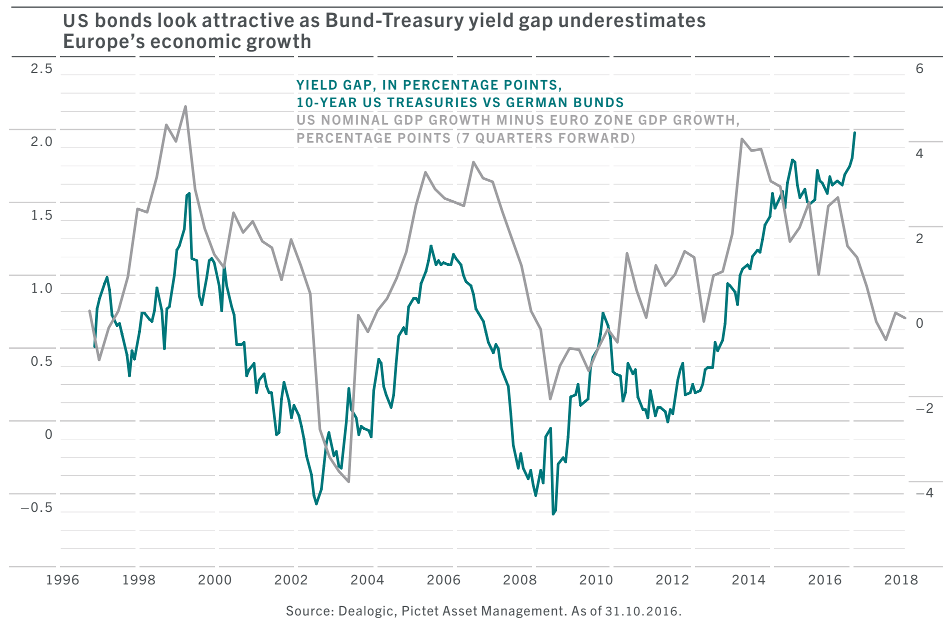
On balance we think that EM stocks should outperform next year on improving fundamentals and we would look to selectively add to our exposure there. Regionally, emerging Europe and Asia look the cheapest with Asia trading at a 10 per cent discount to Latin America – close to a record low and compared with a more typical 10 per cent premium.

When it comes to equity sectors, cyclical stocks are in general well-positioned for the coming year, despite their recent rally. If nominal GDP growth and corporate earnings accelerate as we expect, cyclical stocks should rally to trade in line with their long-term 10 per cent premium to defensive stocks.[2] This compares to the current 4 per cent premium and 10 per cent discount in early July.

Capex related stocks should perform particularly well as corporations step up investment. Financials shares, meanwhile, are set to benefit the most from global reflation due to their cheap valuations and their tendency to respond positively to a steeper yield curve.

2 Based on cyclically adjusted PE ratios.

# Valuations and tighter conditions cast shadow over US high yield



Source: Dealogic, Pictet Asset Management. As of 31.10.2016.

For the bond market, the entwined threats of rising inflation and tightening monetary policy are more unequivocally negative than for other asset classes.

In the developed world, those forces are strongest in the US, where inflation is on track to top 2 per cent for the first time since 2014. Trump's policies are likely to add to inflationary pressures through tax cuts and public spending increases.

Based on the projections of the nonpartisan Committee for a Responsible Federal Budget, we estimate that the budget deficit will nearly double to average 6.1 per cent of GDP over the next decade if Trump's policies are implemented. That is likely to prompt greater monetary policy tightening than previously expected from the Fed, in turn leading to higher US government bond yields and a steeper yield curve.

Historically, the transition from monetary easing/fiscal tightening to the opposite has been negative for bonds and the starting point today is unfavourable due to the asset class's high valuations. We see bond yields moving higher in 2017, especially in Europe where the risk of tighter central bank policy is underappreciated. European bonds also look very expensive compared to their US counterparts: the Treasuries-Bunds yield spread is at 194 bps, the highest since 1990.

Having benefited from the 2016 rally in US high yield bonds, we have now turned neutral on this asset class. On our valuation models – where the cheapest level in history scores 100 and the most expensive scores zero – US high yield has retreated from 75 in February to 11 now. Debt ratios for non-financial companies are at historic peaks and the corporate default rate has risen to a six-year high of 4.8 per cent. These metrics suggest that we are past the peak in the credit cycle.

One notable bright spot in fixed income, particularly when it comes to valuations, is EM local currency debt. As well as offering some of the highest yields in mainstream fixed income, EM corporate bonds tend to have shorter durations, making them less vulnerable to interest rate hikes. The opportunity is far from risk free, however – possible threats to performance include a stronger US dollar and Trump's protectionist stance on global trade.

Among emerging markets, we prefer Latin America due to encouraging signs of progress on structural reform as well as the region's exposure to commodities and energy, whose prices should rise.

With global producer price inflation surging to five-year highs, inflation-linked bonds are starting to look attractive again but we continue to think that gold is a better hedge in the long-term. After the recent price fall, it is also more attractive from a tactical perspective.

In the currency markets, the dollar is indeed likely to strengthen in the coming months due to stronger US growth and the Fed signalling more hikes than are currently priced in. But over the course of 2017 as a whole we expect a very volatile, range-bound performance, with the dollar currently circa 20 per cent overvalued on our models.

Sterling, meanwhile, looks cheap following the steep depreciation since the Brexit vote. The exchange rate is now consistent with fairly dire economic growth. While weak growth may materialise eventually as Britain progresses with the EU exit, we believe that in the short term the UK economy and assets are more likely to exceed expectations, which in turn presents potentially attractive investment opportunities.

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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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