

## **GLOBAL ASSET CLASSES**

We maintain our neutral equity stance as economic growth outside the US remains sluggish.

## **EQUITY REGIONS AND STYLES**

We raise European stocks to overweight as the weak euro should soon boost exports and lift corporate earnings.

## **EQUITY SECTORS**

We maintain a cyclical tilt with overweight positions in energy, materials and industrials.

## **FIXED INCOME**

We increase our exposure to local currency EM debt to neutral, largely because we see scope for a rebound in a number of EM currencies.

# Raising exposure to European stocks

Pictet Asset Management Strategy Unit

Monthly investor outlook on a 3 month view

# Barometer

*October 2014*

# Monthly outlook

Pictet Asset Management  
Strategy Unit

Issued 29 September 2014

## Global market overview

### Stocks outperform bonds; USD shines

World stocks outperformed bonds in September but gains were limited as disappointing data from Europe and Japan eclipsed a positive signal from the US economy. The S&P 500 index briefly hit a record high, before giving up those gains to end lower on the month.

The European Central Bank stepped up the pace of monetary easing - it cut its benchmark lending and deposit rates and outlined plans to buy asset-backed securities and covered bonds. Lacklustre demand for the ECB's new ultra-cheap bank loans - only EUR82.6 billion of new loans were taken up - boosted speculation the central bank would soon have to overcome reservations about sovereign bond buying. The indications from the US Federal Reserve were less clear by comparison. Its official interest rate projections drifted higher but the rhetoric from policymakers remained dovish.

In the currency markets, the USD hit a four-year high against a basket of major currencies amid expectations that US economic growth is now strong enough to prompt the Fed into hiking interest rates in the first half of next year, decoupling its monetary policy from those of the euro zone and Japan.

The USD has been recovering on a trade-weighted basis since the second half of 2011 in tandem with a pick-up in US economic growth (see chart).

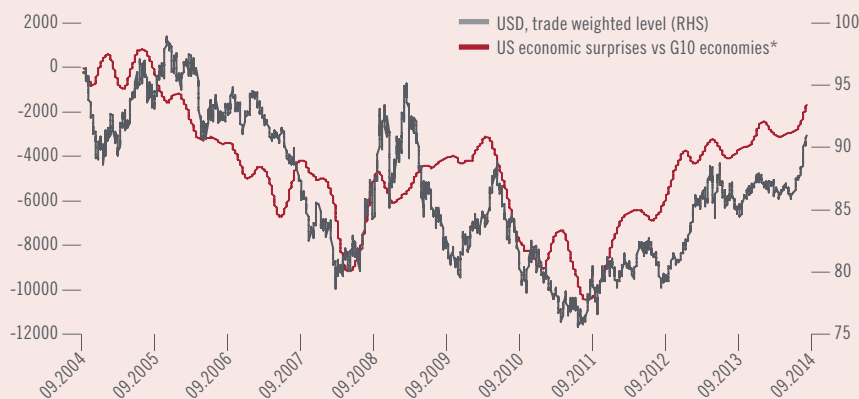
The EUR fell below USD1.27 for the first time in nearly two years as weak business activity data fanned speculation for further monetary

easing from the ECB. The JPY also fell, hitting a six-year low versus the USD of around JPY110, before recovering slightly after Prime Minister Shinzo Abe voiced concern about the economic impact of a sharply depreciating currency. The JPY's latest decline lifted Japanese shares to a seven-year high in local currency terms.

A strong USD also weighed on emerging equities, currencies and bonds. Countries heavily-reliant on external financing, such as South Africa, Turkey and Brazil, saw the biggest declines in their currencies and shares. China stocks lost more than 4 per cent as concerns grew about the cooling housing market and sluggish industrial activity.

In fixed income, expectations for a widening monetary policy split between the US and Europe pushed the gap between two-year US and German bond yields to 63 basis points, the highest since early 2007. More broadly, bond markets ended lower on the month on expectations that the Fed would start raising interest rates early next year. USD-denominated bonds fared better than emerging local currency bonds, which were the worst performers, declining by more than 3 per cent. Commodities came under broad pressure due to a combination of USD strength and worries over a supply glut. Brent crude hit a two-year low as inflated supplies and weak economic data from Europe outweighed rising political tensions in the Middle East. Gold hit an eight-month low, falling nearly 6 per cent on the month.

### USD GAINS AS GROWTH PICKS UP



\*Extent to which economic data releases surpass consensus expectations

Source: Thomson Reuters Datastream, Citigroup

## Asset allocation

### Remain neutral on equities; USD rally underscores policy divergence

We retain our neutral stance on equities as an improving economic outlook in the US and continued monetary stimulus is counterbalanced by a sluggish recovery in Europe, Japan and emerging markets.

Although the risks for stocks appear to be skewed to the upside - not least because recent falls in US inflation point to a possible delay in US interest rate hikes - the decline in our leading indicators is a signal we cannot ignore.

The future trajectory for both bonds and the USD looks clearer, however. The gathering strength of the US economy should serve as a trigger for both a rise in bond yields and a further appreciation in the USD. Indeed, a stronger USD is symptomatic of the economic divergence between the US and the rest of the world. We remain underweight bonds and overweight the USD as a result.

Our **business cycle** readings show a growing gap between the US and the rest of the world. In the US, consumer confidence and business activity are both turning higher, with regional manufacturing indices such as those of the New York and Philadelphia Fed hitting their highest levels since July 2004. The housing market also appears to be regaining momentum. The recent decline in core inflation is temporary in our view and we expect the reading to hit the Fed's target of 2 per cent in the first quarter of next year.

By contrast, euro zone economic activity is losing momentum, especially in Germany, France and Italy. A weak take-up of the ECB's emergency bank loans was disappointing while deflationary pressures remain.

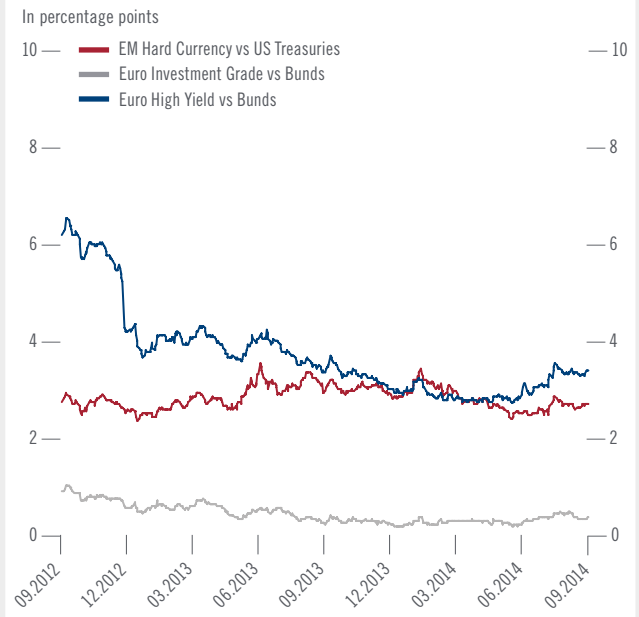
However, lending conditions and corporate demand for loans continue to show signs of improvement.

## MAJOR ASSET CLASSES

PERFORMANCE: ASSET CLASSES

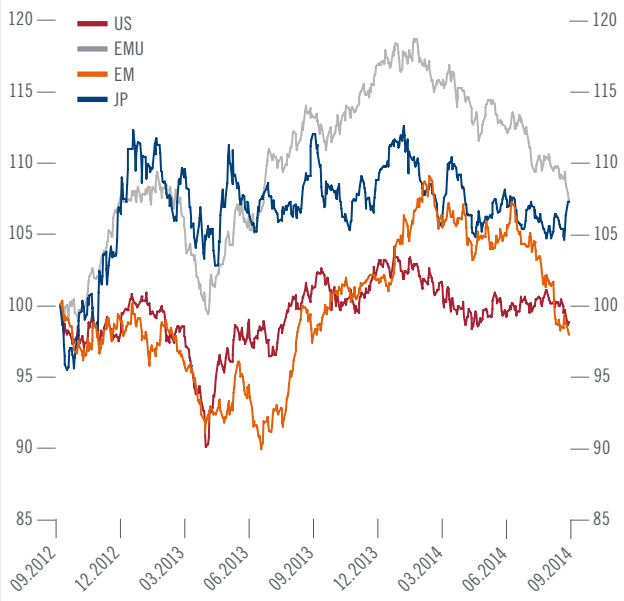


BONDS: ASSET CLASS SPREADS

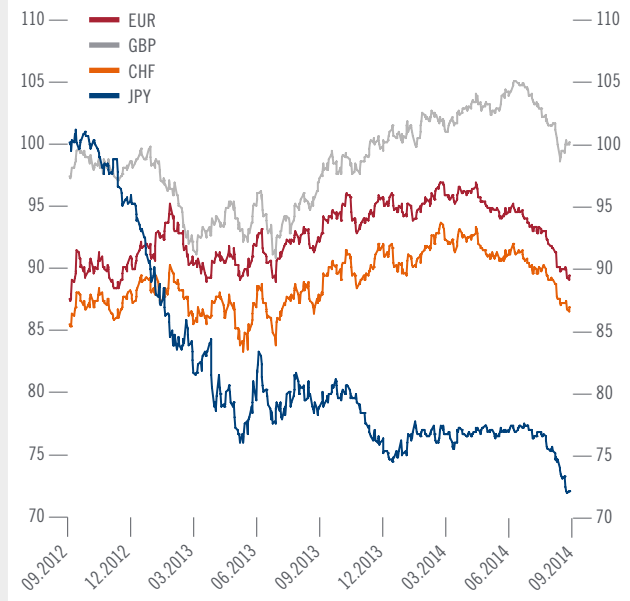


## EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE

GLOBAL EQUITY SECTOR ROTATION:  
PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS



PERFORMANCE: CURRENCIES VS USD

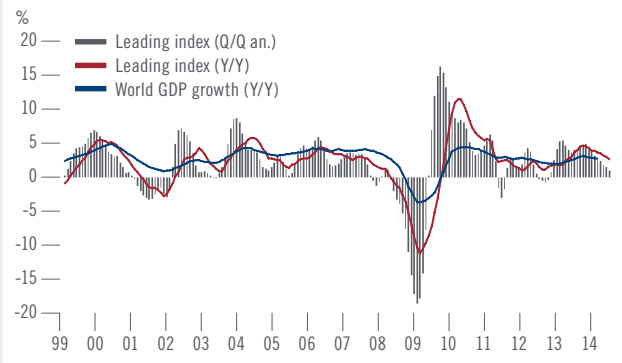


## RISK BIAS INDICATORS

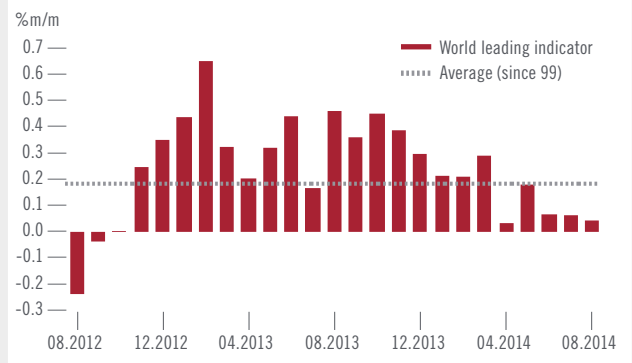
MONTHLY CHANGE Maximum change ◀◀◀◀ ▶▶▶▶		RISK-OFF -	NEUTRAL ○	RISK-ON +
◀		Business cycle		
			Liquidity	
		Valuation		
	▶		Sentiment	
			PAM strategy	

## BUSINESS CYCLE: WORLD ECONOMIC GROWTH REMAINS MODEST

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

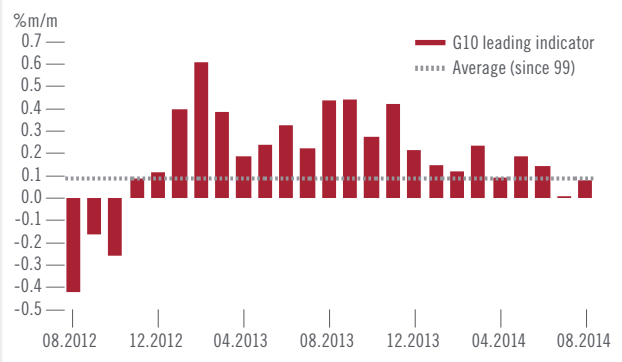


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

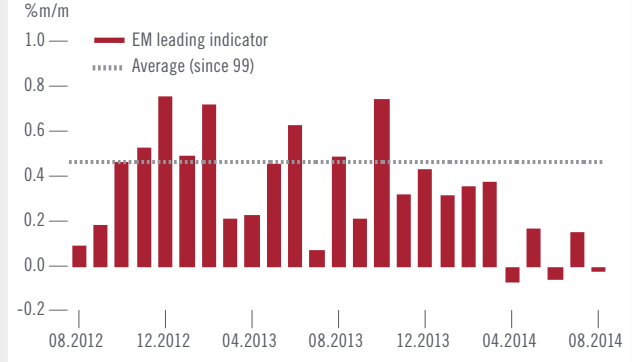


## ECONOMIC MOMENTUM MODEST IN G10; SLIGHT DETERIORATION IN EMERGING ECONOMIES

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



## VALUATION: EQUITY MARKETS AND SECTORS

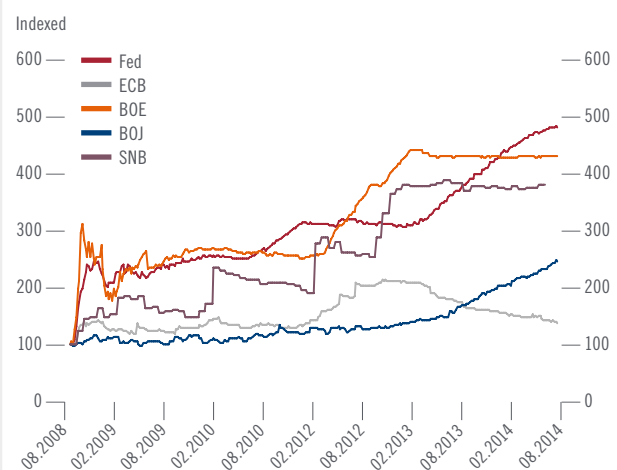
### COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH		SALES GROWTH		PE		PB 2014E	P/SALES 2014E	DY 2014E
	2014	2015	2014	2015	2014	12M			
US	8%	12%	4%	4%	17.1	15.8	2.4	1.7	2.1%
Europe	6%	13%	1%	3%	15.4	13.9	1.7	1.1	3.4%
EMU	9%	17%	1%	3%	15.6	13.9	1.4	0.9	3.3%
Switzerland	1%	12%	2%	4%	17.6	16.4	2.5	2.2	3.1%
UK	2%	8%	0%	2%	14.2	13.6	1.8	1.1	3.7%
Japan	6%	11%	2%	3%	15.0	14.3	1.2	0.7	1.9%
EM	6%	11%	7%	7%	12.0	10.9	1.3	0.7	2.8%
NJA	10%	11%	6%	7%	12.6	11.5	1.4	0.7	2.7%
<b>Global</b>	<b>6%</b>	<b>12%</b>	<b>4%</b>	<b>4%</b>	<b>15.8</b>	<b>14.5</b>	<b>1.9</b>	<b>1.2</b>	<b>2.5%</b>

MSCI GLOBAL SECTORS	EPS GROWTH		SALES GROWTH		PE		PB 2014E	P/SALES 2014E	DY 2014E
	2014	2015	2014	2015	2014	12M			
Energy	8%	7%	2%	2%	12.7	12.0	1.4	0.7	3.3%
Materials	5%	17%	1%	5%	16.0	14.2	1.6	0.9	2.8%
Industrials	11%	13%	4%	5%	16.8	15.3	2.1	0.8	2.4%
Consumer Discretionary	0%	16%	4%	6%	17.1	15.4	2.4	1.0	2.0%
Consumer Staples	4%	10%	3%	5%	19.5	18.1	3.3	1.1	2.9%
Health care	11%	11%	8%	5%	18.9	17.5	3.4	2.0	2.0%
Financials	6%	13%	6%	5%	13.5	12.3	1.2	1.6	3.3%
IT	13%	11%	4%	7%	17.0	15.5	2.9	2.0	1.6%
Telecoms	-4%	9%	2%	3%	16.5	15.5	2.1	1.3	4.2%
Utilities	0%	7%	1%	2%	15.8	15.1	1.4	0.9	4.0%

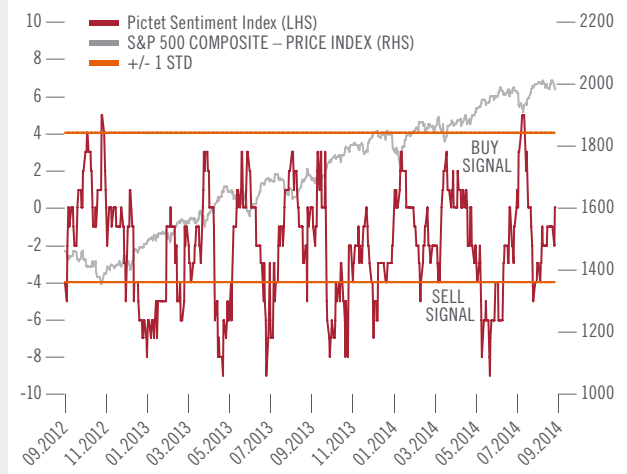
## LIQUIDITY: FED TAPERS BUT MONETARY STIMULUS CONTINUES ELSEWHERE

### SIZE OF CENTRAL BANKS' BALANCE SHEETS



## SENTIMENT INDICATOR SHIFTS TO NEUTRAL

### PICTET SENTIMENT CYCLE INDEX



The clouds hanging over the region's banking sector may finally lift after the ECB completes its bank Asset Quality Review – its health check for European lenders – in October. The recent decline in the EUR is another bright spot, as it is likely to help the region's exporters in the coming months.

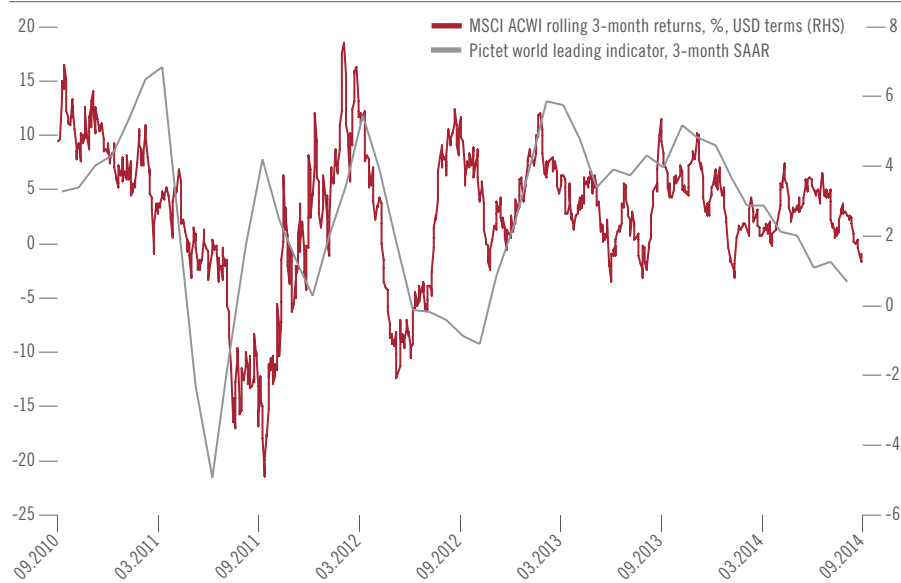
Japan's economic growth remains subdued, evidenced by data showing falling household spending and industrial activity – figures which prompted the government to cut its economic projections for the first time in five months. A steady improvement in the job market and rising wages are perhaps the only bright spots in an economy which is still suffering the effects of the April consumption tax hike.

Against this backdrop, we think it will be difficult for the Bank of Japan to achieve its underlying inflation target of 2 per cent. This may force the BOJ to widen the scope of its quantitative monetary policy in the coming months, including a possible increase of its monetary target.

In China, business activity is easing, with industrial production slowing to its lowest level since 2008. The housing market, which accounts for more than 15 per cent of China's annual economic output, continues to cool, although it should stabilise in the coming months thanks to improving construction activity. The People's Bank of China has injected CNY500 billion into the country's top banks in order to help stabilise the economy and additional easing measures may follow soon.

Growth in emerging economies remains sluggish, and so far the depreciation of EM currencies has failed to reverse the downtrend in our lead indicators there. However, according to

#### DECLINE IN GLOBAL ECONOMIC ACTIVITY SUGGESTS STOCKS WILL REMAIN RANGEBOUND



Source: Thomson Reuters Datastream, Pictet Asset Management

our calculations, emerging currencies are undervalued by 13.5 per cent relative to their long-term equilibrium level and this should support export growth.

**Liquidity** conditions remain benign at a global level. In the US, while the Fed will end quantitative easing in the coming weeks, any tightening of liquidity conditions seems likely to be offset by solid bank loan growth (which is running at an annual rate of about 8 per cent). The liquidity picture in the euro zone is expected to improve as the ECB is set to offer more emergency loans in December and next year, with the aim of expanding its balance sheet towards its 2012 peak of approximately EUR3 trillion from the current EUR2 trillion. It is interesting to note that, while the ECB gives the appearance of being more assertive, its net liquidity provision to the banking sector has halved since 2012.

We also expect liquidity conditions in Japan and China to improve as monetary

authorities mull additional easing measures.

**Sentiment** indicators are mixed at a global level. Investors' surveys show that positioning is much less bullish than in early summer and that hedge funds have trimmed their long positions – indicating that stocks could see further gains. Offsetting that, however, are technical indicators suggesting a shallow correction is likely in the short term.

**Valuations** remain slightly negative for equities but this is normal as the bull market matures. The US, which has led the global equity rally, remains the most expensive market based on relative P/E, while emerging Asia has the most attractive valuations after the region's sharp decline. While we are concerned that earnings forecasts continued to be revised downwards in almost all markets, we continue to believe that bonds are more expensive than equities.

## Equity region and sector allocation

### Long Europe, emerging markets downgraded to neutral

In our regional allocation, we raise Europe to an overweight and cut emerging markets to neutral. We stay underweight US stocks mainly on valuation grounds. Our move to upgrade Europe is a reflection of favourable liquidity conditions in the region and the growth-boosting potential of a weak EUR. The recent improvement in the region's monetary aggregates and a weaker EUR suggest that the risk of deflation - which now appears to be a consensus expectation - may be overstated.

Moreover, the ECB's programme to buy asset-backed securities and covered bonds, designed to revive lending and stave off the threat of deflation, is a last step before full-blown quantitative easing. If these more targeted measures disappoint, there are indications that the central bank will consider large-scale government bond purchases. (But even if the ECB were to refrain from QE that would not necessarily be negative for stocks as it would suggest that economic conditions are improving.) Although valuations for European stocks are not especially compelling, this is mainly due to the fact that corporate earnings levels remain unusually low at this point in the cycle.

Emerging markets have also seen their currencies fall against the USD in recent weeks. This will enhance developing economies' export competitiveness at a time when external demand is rising. Valuations are still supportive for emerging stocks, even if the discount at which the asset class trades to developed markets has narrowed to 20 per cent from 30 per cent last March. However, these positives are tempered by weak economic momentum and capital outflows from equity investors.

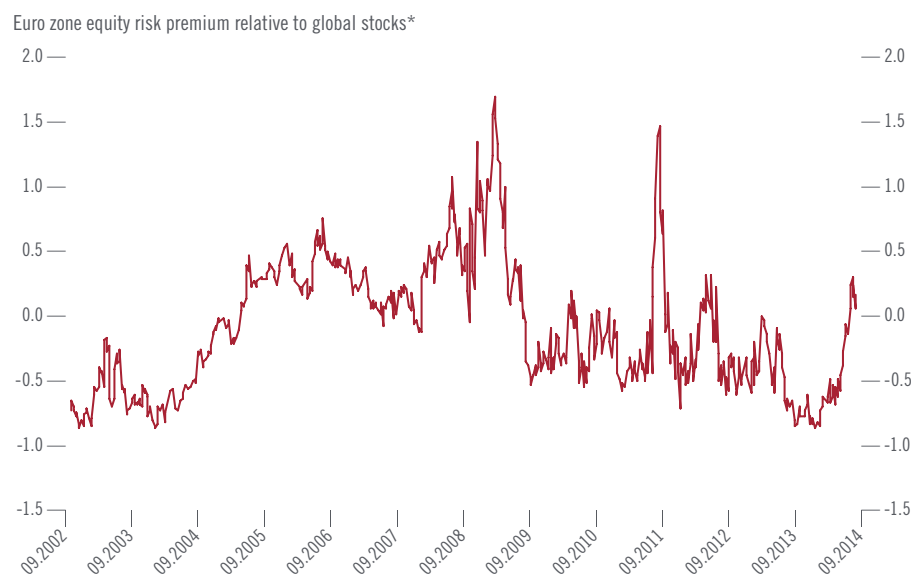
Our cautious stance on the US reflects our concerns over slightly unfavourable liquidity conditions and lofty valuations. Although our business cycle indicators continue to point to strong growth momentum, US equity gauges have climbed to all-time highs; moreover, a valuation of 15.8 times 12-month forward earnings appears expensive on our scorecard. We think this poses some risks, particularly at a time when the Fed is withdrawing monetary stimulus.

We retain our neutral view on Japan. Japanese stocks are trading more or less in line with the broader market. Although the central bank is likely to continue providing monetary stimulus, a potential second increase in the consumption tax is a concern, particularly as the first hike in April of this year took a greater toll on the economy than had been expected.

Investor positioning on Japanese stocks also seems overly-bullish following a move that took the Nikkei index to its highest level since 2007.

In our sector allocation, we continue to favour cheap cyclical stocks. That view is expressed through an overweight in energy, materials and industrials. The energy sector has corrected in tandem with the sharp decline in the oil price this month, and is now the cheapest sector on our scorecard. We think the sector shows the potential for a rebound, particularly as the oil price stands near the bottom of its trading range and increased geopolitical risk continues to raise the prospect of possible disruptions to production. Financials should benefit from rising US interest rates and an improving outlook for credit. Our least favoured sector remains healthcare given rich valuations and heavy investor positioning.

#### EUROPE'S EQUITY VALUATIONS NO LONGER HIGH VS GLOBAL PEERS



\*as measured by gap in earnings yield and 10-year bond yield, data taken from MSCI Euro zone, MSCI World and Citigroup government bond indices

Source: Thomson Reuters Datastream

## Fixed Income

### Warming to local currency emerging market debt

The appeal of local currency emerging market debt is growing as valuations for both bonds and currencies drift to levels that are at odds with such countries' longer-term economic prospects. This is especially true of emerging market currencies, which in aggregate are trading some two standard deviations below what our models indicate as fair value. We have consequently shifted our stance on the asset class from underweight to neutral. We remain selective, however. The Brazilian real and the Turkish lira are among the currencies that exhibit the strongest potential for a rebound in the short term, in our view, while currencies such as the Russian rouble remain hostage to geopolitical risks.

Valuations for certain bond markets are also extremely attractive. Peso-denominated Mexican government bonds look especially appealing now that the extra yield they offer over US Treasuries has risen to lofty levels (the spread between Mexican and US 5y5y rates is at an unjustifiably high 400 basis points).<sup>1</sup> To fund this position, we have reduced our exposure to emerging corporate debt to neutral from overweight. This reduction in part reflects our concerns over trading conditions in the market – liquidity is not as favourable as it once was.

Liquidity also appears to be deteriorating in other parts of the corporate bond market, especially within high-yield debt, where there is a growing imbalance between the volume of securities in investment funds, which continues to grow, and the inventories

held by market-makers in the asset class, which are heading in the opposite direction. The provision of daily liquidity by several US high-yield exchange-traded funds also has the potential to amplify price moves, particularly if a large number of investors look to sell their holdings at the same time. As a result, we remain neutral non-investment grade bonds. We now have a neutral stance across all credit categories as we have generally become more cautious on global credit risk.

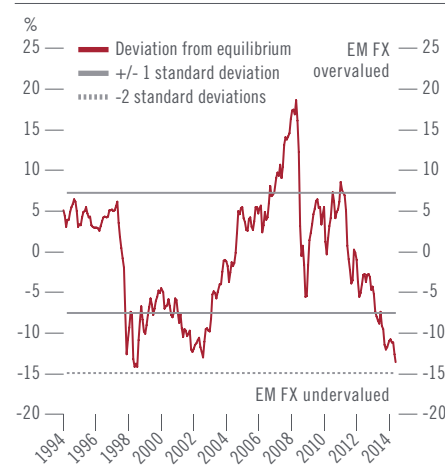
Elsewhere we have locked in some gains on a number of long-held currency positions. We have, for instance, reduced our underweight on the JPY versus the USD by a considerable margin in recent weeks following the currency's recent depreciation. The recent decline in the EUR versus the USD has encouraged us to do the same with our short EUR position, but not to the same extent. Although we have slightly reduced our short position on the EUR, the prospect of additional monetary stimulus from the ECB and a tightening of the monetary reins in the US suggests the single currency could head lower still.

Looser monetary policy should, however, have less of an effect on euro zone government bonds, particularly those of Italy and France, which are already trading at expensive levels.

Olivier Ginguené, *Chairman*  
*Pictet Asset Management Strategy Unit*

Luca Paolini, *Chief strategist*  
*Pictet Asset Management*

#### EM CURRENCIES SIGNIFICANTLY BELOW FAIR VALUE



Source Pictet Asset Management

#### ABOUT THE PSU

The Pictet Asset Management Strategy Unit (PSU) is the investment group responsible for providing asset allocation guidance across stocks, bonds, cash and commodities.

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)

<sup>1</sup> 5y5y rates refer to investor expectations of what the five-year rate would be in five years' time

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