PICTET 1805

	UNDERWEIGHT –		NEUTRAL ○		OVERWEIGHT +	MONTHLY CHANGE Maximum change ◀◀◀◀ ▷▷▷▷
GLOBAL ASSET CLASSES We keep a positive stance on equities as economic conditions continue to improve; we stay underweight bonds on valuation grounds.						
Equities				Equities		
Bonds		Bonds				
Cash			Cash			
Gold				Gold		▷
Oil			Oil			
USD				USD		
EQUITY REGIONS AND STYLES We increase European equities to overweight as the region will benefit from a weaker euro and falling oil prices; we reduce our exposure to the US.						
Japan				Japan		
US	US					◀
Europe				Europe		▷
Pacific			Pacific			
Emerging			Emerging			
Mid & Small Cap		Mid & Small Cap				
Value			Value			
EQUITY SECTORS We stay overweight energy as we believe oil prices are near the bottom of a new trading range; consumer discretionary remains our main sector overweight.						
Energy				Energy		
Materials			Materials			
Industrials			Industrials			
Consumer Disc					Consumer Disc	
Consumer Staples			Consumer Staples			
Healthcare		Healthcare				
Financials				Financials		
IT		IT				
Telecoms		Telecoms				
Utilities		Utilities				
FIXED INCOME We remain overweight both local and hard currency EM debt; investment-grade and high-yield bonds are expensive.						
EUR Government		EUR Government				
EUR Investment Grade		EUR Investment Grade				
EUR High Yield			EUR High Yield			
EMD Hard (USD)				EMD Hard (USD)		
EMD Local				EMD Local		
EM Corporate			EM Corporate			

ECB boosts stocks' appeal

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

February 2015

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 2 February 2015

Global market overview

Equities underperform bonds; USD and CHF advance

Equities slightly underperformed bonds in January as concerns grew about the outlook for the global economy. The US was the biggest loser in global equity markets as the decline in oil prices pressured energy shares and expectations grew that the US Federal Reserve would raise interest rates later this year.

European shares rallied and the EUR hit an 11-year low against the USD after the European Central Bank took the historic step of buying sovereign bonds to help support the economy and boost lending. The larger-than-expected programme, under which ECB will commit to buying up to EUR60 billion of bonds a month until at least 2016, will boost the central bank's balance sheet to above EUR3 trillion.

The market became slightly unsettled by the victory of the anti-austerity Syriza party in the Greek election, which raised the prospect of a stand-off between Athens and international creditors, rekindling concerns over the stability of the 19-nation bloc.

Emerging equities, especially in Asia, outperformed their developed counterparts as the prospect of easier monetary policy supported risk appetite. India, Turkey and Singapore joined a list of emerging countries to relax monetary policy to fight deflation and slow growth. The yield on the GBI-EM local currency debt index fell below 6.2 per cent, the lowest since mid-2013.

Currency volatility featured prominently in January after the Swiss National Bank shocked investors by scrapping the CHF's peg against the EUR. The CHF rallied strongly in the currency markets, hitting an all-time high against the EUR (see chart); it also gained against the USD.

The USD advanced a further 4 per cent in the month against major currencies, building on last year's 11 per cent gain. The Russian rouble, already under pressure because of renewed fighting in Ukraine and the threat of fresh Western sanctions, fell more than 10 per cent as oil stayed under USD50 a barrel and ratings agency S&P downgraded the country's sovereign credit rating to junk. After some wild moves in recent weeks, the measure of implied volatility in currency markets[1] rose to a 2-1/2 year high.

The ECB's latest stimulus plan gave fresh legs to the broad-based bond rally. The benchmark 10-year German yield fell to record lows near 0.3 per cent while other euro zone bond yields held near record troughs. The 30-year US Treasury yield hit a record low around 2.3 per cent as worries mounted that falling oil prices and slow world growth may weigh on US businesses.

SCRAPPING OF CHF PEG SPARKS RALLY VS EUR

Source: Thomson Reuters Datastream

[1] JP Morgan global FX implied volatility index, source Thomson Reuters Datastream

Asset allocation

Central bank support to drive equities higher

We maintain our overweight stance in equities as continued monetary support from the world's central banks and improving global growth underpins risk appetite, even as the Fed edges closer to raising interest rates. We remain underweight bonds on valuation grounds and continue to hold an overweight stance on the USD. As a hedge against the possibility of an increase in market volatility, we have also raised our exposure to gold.

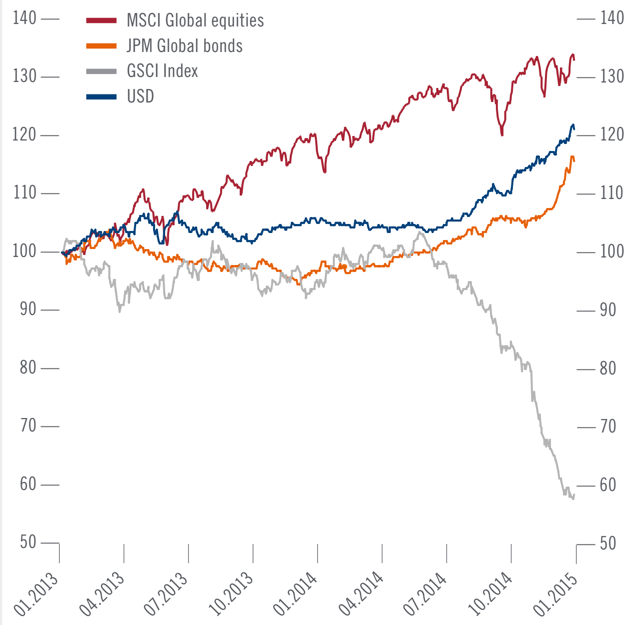
Our **business cycle** readings are positive at a global level, with our leading indicators registering the second steepest rise since May. The fall in oil prices is a major boost to economic activity as it is likely to add 0.8 percentage points to global growth this year, with Europe, Japan and Asia the biggest beneficiaries. The ECB's decision to buy sovereign bonds and interest rate cuts in a number of emerging economies are likely to lift this year's net central bank liquidity injection to USD1.3 trillion, above the 2014 levels, providing a strong support to world growth.

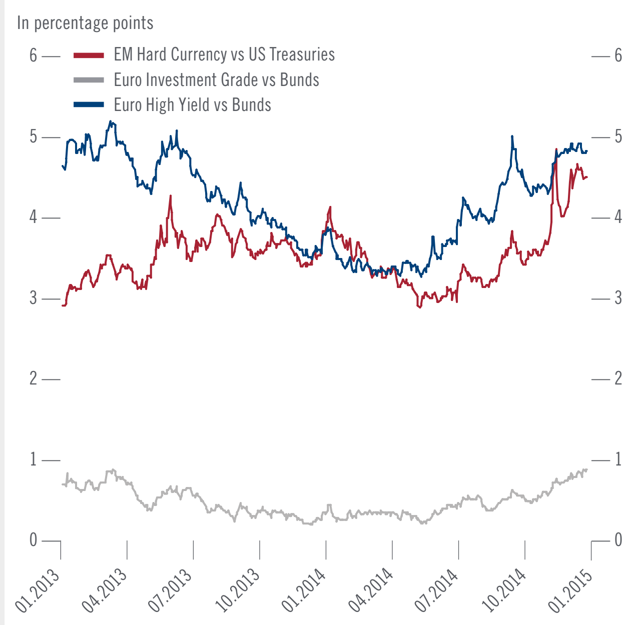
Economic momentum remains positive in the US, where strength in the housing sector is likely to help lift GDP growth to 3 per cent this year, in our view. Lower oil prices have pushed consumer confidence to the highest level in 14 years, although activity data has yet to show improvement in retail spending. Inflationary pressures have declined further but we expect wage growth to steadily pick up, allowing the Fed to raise interest rates in the second half of this year.

We also see improvement in the euro zone, where leading indicators posted the second consecutive month of recovery. Consumer confidence has risen in both core and peripheral economies, while credit growth has also picked up smartly after banks relaxed their

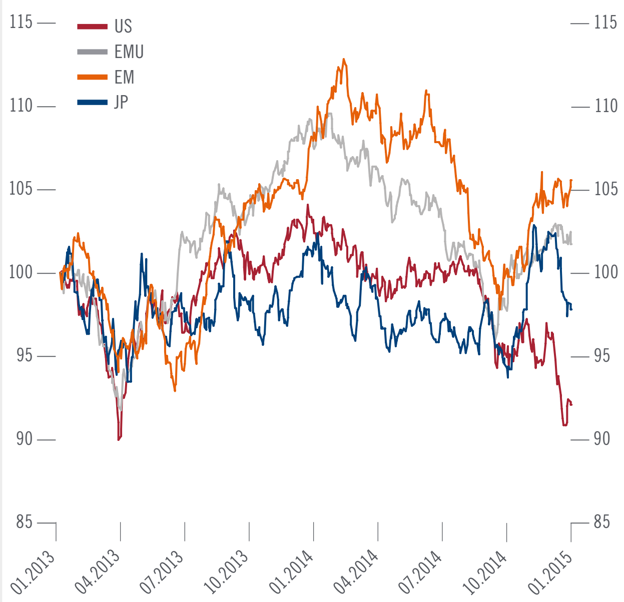
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

MAJOR ASSET CLASSES





EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE



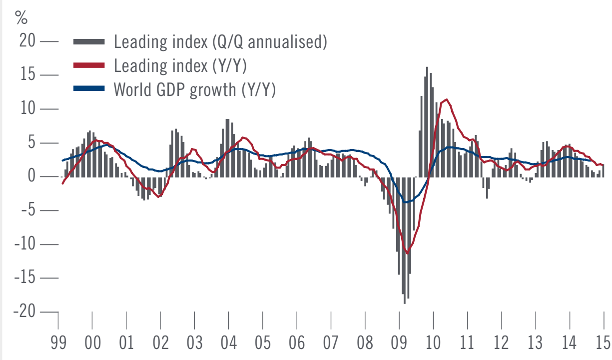
Source: Pictet Asset Management, Thomson Reuters Datastream

RISK BIAS INDICATORS

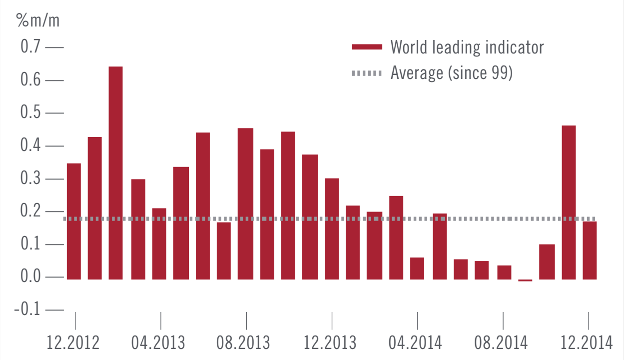
MONTHLY CHANGE Maximum change ◀◀◀◀ ▷▷▷▷		RISK-OFF –		NEUTRAL o		RISK-ON +	
					Business cycle		
					Liquidity		
				Valuation			
				Sentiment			
					PAM strategy		

BUSINESS CYCLE: WORLD ECONOMIC GROWTH CONTINUES TO BUILD

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

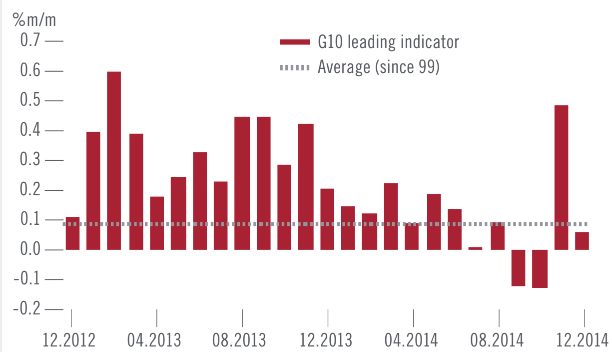


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

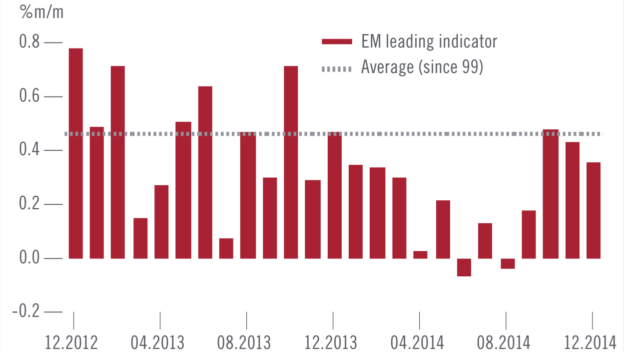


ECONOMIC MOMENTUM REMAINS POSITIVE AT A GLOBAL LEVEL

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



Source: Pictet Asset Management, Thomson Reuters Datastream

VALUATION: EQUITY MARKETS AND SECTORS

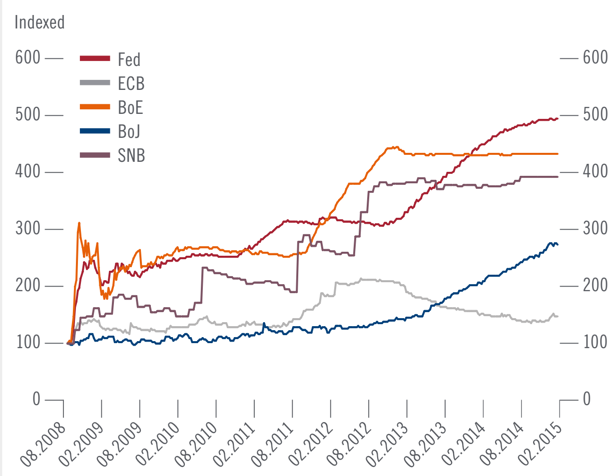
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH 2014	EPS GROWTH 2015	SALES GROWTH 2014	SALES GROWTH 2015	PE 2014	PE 12M	PB 2014E	P/SALES 2014E	DY 2014E
US	7%	5%	3%	3%	17.5	16.4	2.5	1.7	2.1%
Europe	2%	7%	-2%	2%	15.9	14.8	1.7	1.1	3.4%
EMU	5%	15%	-3%	3%	17.0	14.7	1.5	1.0	3.1%
Switzerland	0%	5%	2%	4%	17.3	16.3	2.5	2.0	3.2%
UK	-2%	-3%	-2%	-1%	14.3	14.5	1.8	1.1	3.8%
Japan	10%	11%	3%	3%	15.6	14.2	1.3	0.7	1.8%
EM	0%	10%	5%	5%	12.7	11.5	1.4	0.7	2.8%
NJA	7%	10%	5%	5%	13.4	12.1	1.4	0.7	2.6%
Global	**4%**	**6%**	**3%**	**3%**	**16.4**	**15.2**	**1.9**	**1.2**	**2.4%**

MSCI GLOBAL SECTORS	EPS GROWTH 2014	EPS GROWTH 2015	SALES GROWTH 2014	SALES GROWTH 2015	PE 2014	PE 12M	PB 2014E	P/SALES 2014E	DY 2014E
Energy	-3%	-30%	-2%	-8%	11.7	16.3	1.3	0.7	3.7%
Materials	-1%	7%	0%	3%	15.8	14.6	1.6	0.9	2.9%
Industrials	8%	13%	4%	4%	17.5	15.4	2.1	0.9	2.4%
Consumer Discretionary	-2%	16%	4%	6%	18.6	16.0	2.6	1.1	1.9%
Consumer Staples	2%	6%	2%	5%	21.2	19.7	3.7	1.2	2.7%
Health care	12%	9%	9%	6%	20.2	18.3	3.8	2.1	1.8%
Financials	5%	12%	4%	5%	13.6	12.0	1.2	1.7	3.2%
IT	13%	10%	3%	7%	17.4	15.5	3.0	2.1	1.6%
Telecoms	-5%	6%	2%	3%	17.1	16.0	2.2	1.3	4.1%
Utilities	5%	6%	1%	2%	16.4	15.5	1.5	1.0	3.6%

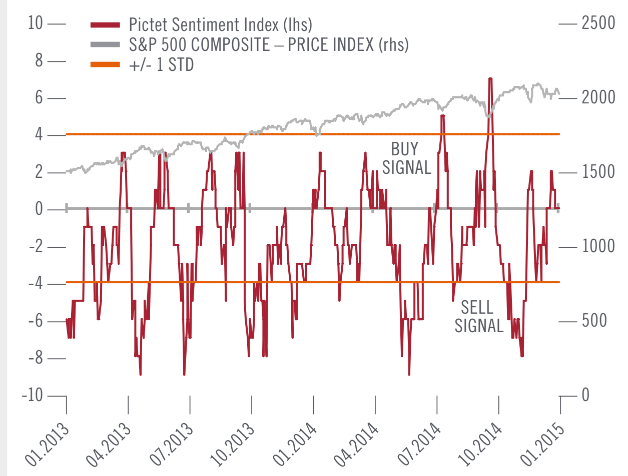
LIQUIDITY: FED ENDS QE BUT MONETARY STIMULUS CONTINUES ELSEWHERE

SIZE OF CENTRAL BANKS' BALANCE SHEETS



SENTIMENT INDICATOR GIVES NEUTRAL SIGNAL

PICTET SENTIMENT CYCLE INDEX



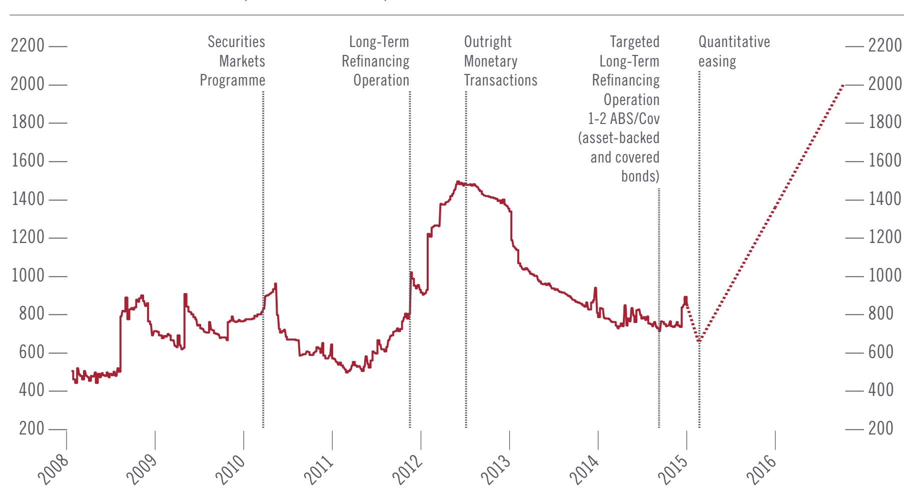
lending standards and loan demand from corporates increased, as evidenced by the ECB's Lending Standards Survey. Mortgage rates have also fallen in core and some peripheral economies, a trend which we expect to gather pace in the coming months especially as the ECB expands its balance sheet.

By contrast, economic indicators in Switzerland have turned sharply negative after the Swiss National Bank's move to abandon its EUR peg resulted in a sharp appreciation of the CHF, which by our calculations was the equivalent of a 400 basis point hike in interest rates for the heavily export-dependent economy. We expect the economy to contract by 0.5 per cent this year, compared with our previous estimate for growth of 2 per cent; inflation is likely to fall by up to 3 per cent in a worst case scenario. Our forecast if for the CHF to trade at EUR1.10 by year-end.

Economic momentum decelerated in Japan with disappointing industrial production data and retail sales suggesting the economy is climbing out of recession only very slowly. Inflationary pressure remains low as there is no material evidence yet that Japanese companies are raising wages. The Bank of Japan, nevertheless, is committed to generating a sustainable growth and achieving a 2 per cent inflation target, and it may expand its monetary stimulus further later this year.

Business cycle readings in China remain mixed. The economy continues to recover from an early 2014 dip triggered by a slowdown in the property sector and the People's Bank of China's recent interest rate cut and other easing measures should be supportive. However, liquidity conditions are still challenging. The appreciation of the CNY on a trade-weighted terms will weigh on corporate spending. The economy is on track to achieve long-term growth of 6.5 per cent, after a 7.4 per cent expansion in 2014. More broadly, we expect exports in other emerging economies to recover as external demand picks up. Weaker emerging currencies are also beneficial – on our fair value model, EM currencies are undervalued by 22 per cent.

NET LIQUIDITY INJECTION, EUR BILLIONS, ECB*



*Bond purchases minus proceeds from money market operations and maturing bonds/loans

Source: European Centrall Bank, Pictet Asset Management

Our **liquidity** signals are positive, helped by the latest monetary stimulus in the euro zone and a number of interest rate cuts in emerging economies. The improvement in credit conditions is particularly stark in Europe: surveys suggest that demand and supply of bank loans are building both in the non-financial and in the household sector. That this coincides with the ECB quantitative easing programme is promising as it suggests lending could begin to accelerate and deliver the desired economic boost. Japan is giving equally strong signals but the US stands among developed markets as being weak, no doubt feeling the effects of the Fed's steady withdrawal of monetary stimulus. China, having experienced buoyant conditions in the previous two months, saw a deterioration in December, however.

Sentiment readings indicate investors have shifted to a more neutral stance, which suggests there is more limited scope for a correction in equities. Our investment flow analysis shows hedge funds have scaled back bullish positions over the past four weeks. A similar picture emerges from our exchange-traded fund flow readings, which also point to a scaling back of bullish positions.

Valuation readings are also neutral, with the US still the most expensive stock market on our scorecard. Defensive sectors such as health care and consumer staples look expensive, while energy shares are the cheapest. Equities remain cheap relative to fixed income although they look less attractive when compared to other indicators which we consider as proxies for economic growth.

Equity region and sector allocation

Europe upgraded as economy begins to turn the corner

In our regional allocation, we raise European equity to an overweight from neutral and cut US to a full underweight. Emerging markets are maintained at benchmark weight.

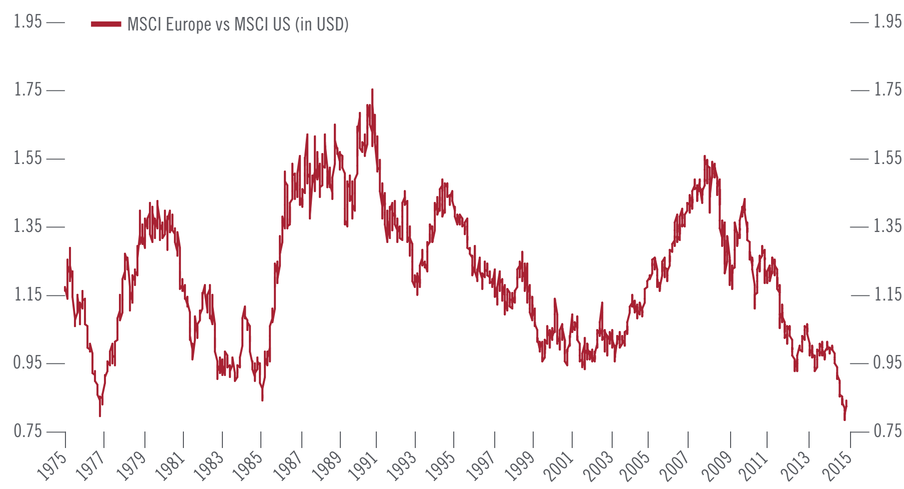
European equities are upgraded to reflect the region's increased economic momentum, improving liquidity conditions and favourable valuations, as adjusted over the business cycle.

The economic picture has been gradually improving in Europe, thanks to the combined effect of a weaker EUR and lower oil prices. Manufacturing surveys point to stronger activity and private consumption has also been on the rise. For the first time in nine months, the economic surprise index – which tracks the extent to which data surpasses or undershoots consensus forecasts - has turned positive. An adverse outcome to the debt negotations between Greece and its credits remains a risk but we expect the discussions to eventually deliver a compromise.

Liquidity conditions are also supportive. The ECB's expansion of its asset purchase programme to government bonds unveiled on 22 January went further than many had thought. But its timing is also crucial – the ECB's lending surveys show banks are more willing to lend and that private borrowers are keen to take on debt.

Valuations for European stocks do not look especially compelling in absolute terms. However, on a cyclically-adjusted basis, the discount at which they trade against their US counterparts remains wide by historical standards. According to Shiller's price-earnings ratios, European equities trade at a record discount of some 33 per cent versus US stocks. This is due to the fact that earnings in Europe are some 30 per cent below their 2008 peak, an unusually low level that is unlikely to persist. Earnings momentum has improved in the region, and our forecast is for some 15 per cent earnings growth for 2015, which looks achievable, particularly in light of the boost to exporters from the lower EUR. Moreover, in USD terms, European indices trade at a record low relative to the US (see chart).

EUROPEAN STOCKS TRADE AT RECORD LOWS VS US PEERS



Source: Thomson Reuters Datastream

The US market looks more vulnerable. The region's stocks are the most richly valued on our scorecard, and this poses risks, particularly as the Fed is about to raise interest rates. The earnings season has been lacklustre and the strong dollar could start to bite into US companies' margins.

Japan remains attractive from a valuation and liquidity perspective. The region's stocks look especially appealing from a price-to-book and or price-to-sales perspective (1.3 and 0.7, respectively) and the central bank could face pressure to ease monetary conditions if inflation pressures continue to ease.

We retain our neutral view on emerging equities. Extremely cheap currencies and an improving global growth outlook are supportive for EM equities, but concerns about liquidity conditions in China prevent us from turning more positive.

When we turn to sectors, we keep a preference for cyclical stocks. Our forecast is for global growth to accelerate and this will favour the sectors most exposed to the economic cycle, which are currently cheaper than defensive peers. We favour consumer discretionary stocks which should benefit from stronger consumer confidence, and the impact of lower energy prices and a stronger USD on household spending. The energy sector is the cheapest on our scorecard and we think the sectors shows the potential for a rebound, particularly as the oil price is trading near the bottom of what we believe is a new lower trading range of USD50-70.

We are underweight defensive sectors such as health care and utilities which tend to underperform when bond yields rise. The health care sector looks particularly unappealing given rich valuations and heavy investor positioning in such stocks.

PICTET
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Pictet Asset Management Limited
Moor House
120 London Wall
London EC2Y 5ET

www.pictet.com
www.pictetfunds.com

Fixed Income

EM bonds continue to offer favourable return prospects

We retain our overweight stance on emerging market bonds – both USD and local currency – at the expense of developed market fixed income assets, which are expensive on the whole.

Even if growth in the developing world has been moderating relative to the US and other advanced nations over the past several months, the yield pick-up offered by emerging market fixed income is more than sufficient compensation.

Moreover, persistently aggressive monetary stimulus in the euro zone and Japan is sure to boost the allure of high-income assets for some time to come – and USD emerging debt could benefit disproportionately. Also likely to have a positive bearing on returns are demand and supply dynamics – sovereign issuers in the developing world are expected to raise less than they did last year; some estimates put sovereign gross issuance coming in 25 per cent lower than in 2014.

Local currency emerging market debt also has attractive characteristics and could see demand rise among euro based investors in particular given the likely trajectory of the EUR. That said, we expect the dispersion of returns across countries and currencies to remain high.

We retain a neutral stance on European high-yield bonds. Although the asset class's investment appeal has grown, thanks in large part to ECB QE, the drop in oil prices and the export-boosting fall in the EUR, valuations are less attractive compared to emerging market debt.

We continue to maintain a lower-than-index exposure to government bonds and have further reduced the duration of the portfolio. Negative yields are now a feature of vast swathes of the government bond landscape while even ultra-long maturity debt is uninspiring. The yield on the 30-year US Treasuries, for instance, is at a record low (see chart). We also believe the market has become too pessimistic in pricing in the prospect of deflation becoming entrenched.

In Europe, the higher-than expected size of the ECB's government bond buying programme will keep yields supressed in the near term. Nevertheless, we expect yields in core government bond markets such as Germany to eventually move higher once economic conditions improve and spreads on bonds issued by southern European countries to remain tight.

When it comes to currencies, our short EUR, long USD position remains in place. One of the aims of the ECB's QE policy is to weaken the EUR and – through that – trigger an export-driven recovery and a rise in imported inflation. So far, ECB President Mario Draghi will have been encouraged by what he has seen. The EUR has lost more than seven per cent on a trade-weighted basis since its peak in March last year and is now below its fair value, as indicated by our model.

The depreciation is unlikely to end there. Currencies that slip into a depreciation pattern have a tendency to break substantially below their fair value – a typical overshoot is around one standard deviation. For the EUR, this would mean a further depreciation of some 5 per cent or so on a trade-weighted basis. We believe the EUR could feasibly end up trading at parity with the USD although expect some resistance to emerge once it hits the USD1.10 level. If it breaches that, a move to parity becomes highly likely.

Olivier Ginguené, Chairman
Pictet Asset Management Strategy Unit

Luca Paolini, Chief strategist
Pictet Asset Management

US 30-YEAR GOVERNMENT BOND YIELD HITS ALL TIME LOW

Source: Bloomberg

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)

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