PICTET
Asset Management

MONTHLY ASSET ALLOCATION VIEWS
February 2020

Barometer: Going viral

With the global economy at the mercy of the coronavirus outbreak, investors should consider shoring up their defences in the near term.

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Asset allocation: shoring up defences

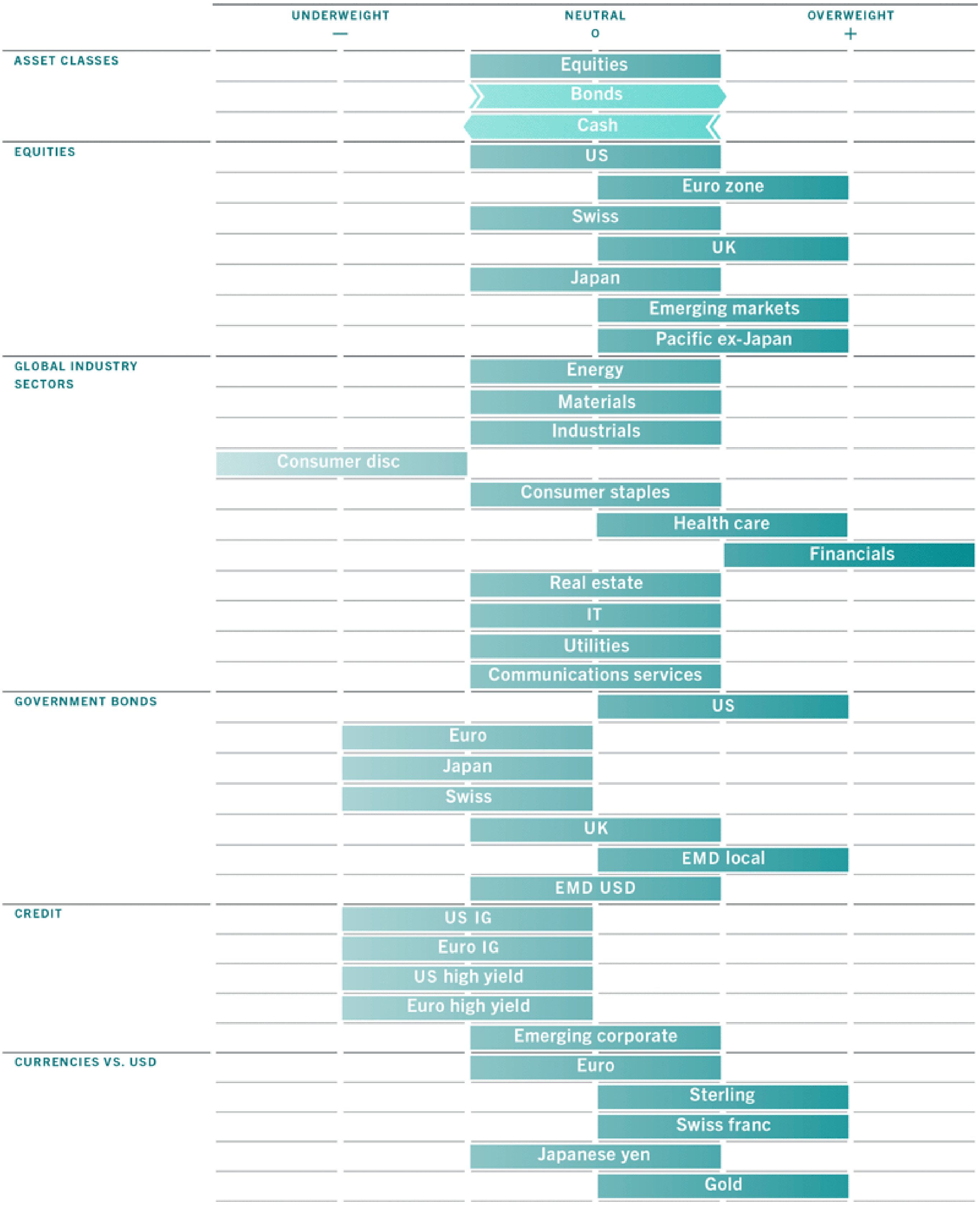
Investors are trying to get a handle on the likely impact of the coronavirus sweeping through China.

The virus's ultimate impact is still unclear to epidemiologists: they don't yet have a proper understanding of how infectious and deadly the virus really is and to what degree it can be spread before the victim shows symptoms. It could prove to be little more than another variation on the seasonal flu bug. Or something altogether more malign – the World Health Organisation has designated it as a global emergency.

For now, investors are drawing parallels with the previous big coronavirus epidemic to spread from China, SARS in 2003 (see Fig. 2). Then, the initial market reaction was severe, reflecting SARS' high mortality rates, and its immediate negative effects on the Chinese economy. But because the epidemic was quickly contained, the rebound was just as sharp, leaving little net economic effect for the year. A repeat of this outcome would reinforce a positive case for emerging markets. Still, there are differences between what is unfolding now and what occurred in 2003. The coronavirus seems less deadly, but is also less easy to contain. And, critically, China's share of the global economy is four times larger than it was in 2003.

Fig. 1 Monthly asset allocation grid

February 2020



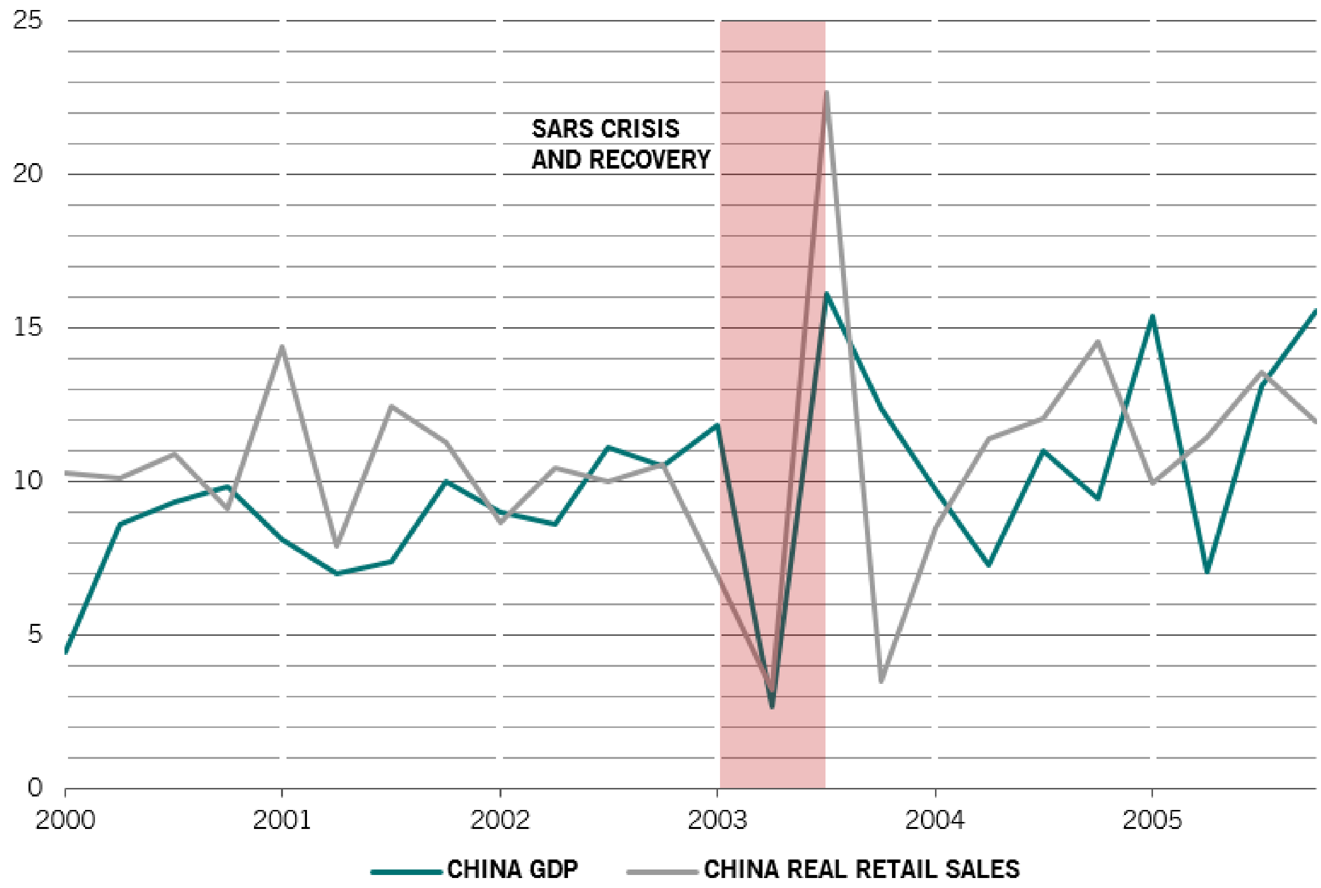
Source: Pictet Asset Management

The US Federal Reserve chairman Jerome Powell has already said he’s watching developments closely – as are his peers around the world. China's central bank added an emergency dose of liquidity to soften the blow to its markets when trade resumed after the New Year holiday. But fiscal measures are likely to have a more immediate impact on the wider economy. The Chinese government slashed tax rates during the SARS crisis and is likely to do something similar again to mitigate the hit to domestic demand and to production if quarantines continue significantly beyond the Lunar new year holidays. And there’s likely to be an acceleration of infrastructure spending later in the year. Taking all this into account, we retain our neutral stance on equities but increase weightings in more defensive assets, changing our stance on bonds to neutral from underweight.

Setting aside the risks posed by the coronavirus, particularly to Asian economies, our **business cycle** model registers a broadly balanced outlook across much of the world, though the US is looking more buoyant. Business sentiment has broadly rebounded from last year’s lows.

Fig. 2 SARS whiplash

Quarter-on -quarter change in Chinese GDP and retail sales growth, %, annualised



Source: Pictet Asset Management, CEIC, Refinitiv. Data covering period 31.12.1999-31.01.2020

Our **valuation** model is running up red flags over the US equities market. By contrast the British and Japanese equity markets continue to trade at attractive levels relative to their fundamentals.

After a massive rally, gold is starting to look expensive – though in a world of paltry yields and a surfeit of risks, it remains an attractively-priced hedge.

Our **liquidity** readings are broadly stable, with USD1.2 trillion of central bank monetary injections – equivalent to some 2 per cent of global GDP – forecast for this year. The market, however, is pricing in even bigger volumes of stimulus, which is potentially a recipe for disappointment, though China's response to the coronavirus could yet make up some of that shortfall.

Our **technical** indicators continue to flash green, particularly now that positive seasonal factors come into play. However, there are warning signs for a handful of assets: high yield bonds, technology stocks and the Mexican peso all look fully overbought according to our models.

02

Equities regions and sectors: the search for value

The breaking of records has been a common occurrence in global equity markets, and January was no exception. The month featured fresh peaks for both the MSCI All Country World Index and the S&P 500.

Stocks are consequently looking a little expensive, with valuations harder to justify amid mounting worries over the likely negative economic impact from the coronavirus outbreak.

In such an environment, we believe ‘value’ stocks are more appealing than their ‘growth’ counterparts. That means being overweight financials. They are among the cheapest equity sectors, and are also set to benefit from central bank stimulus.

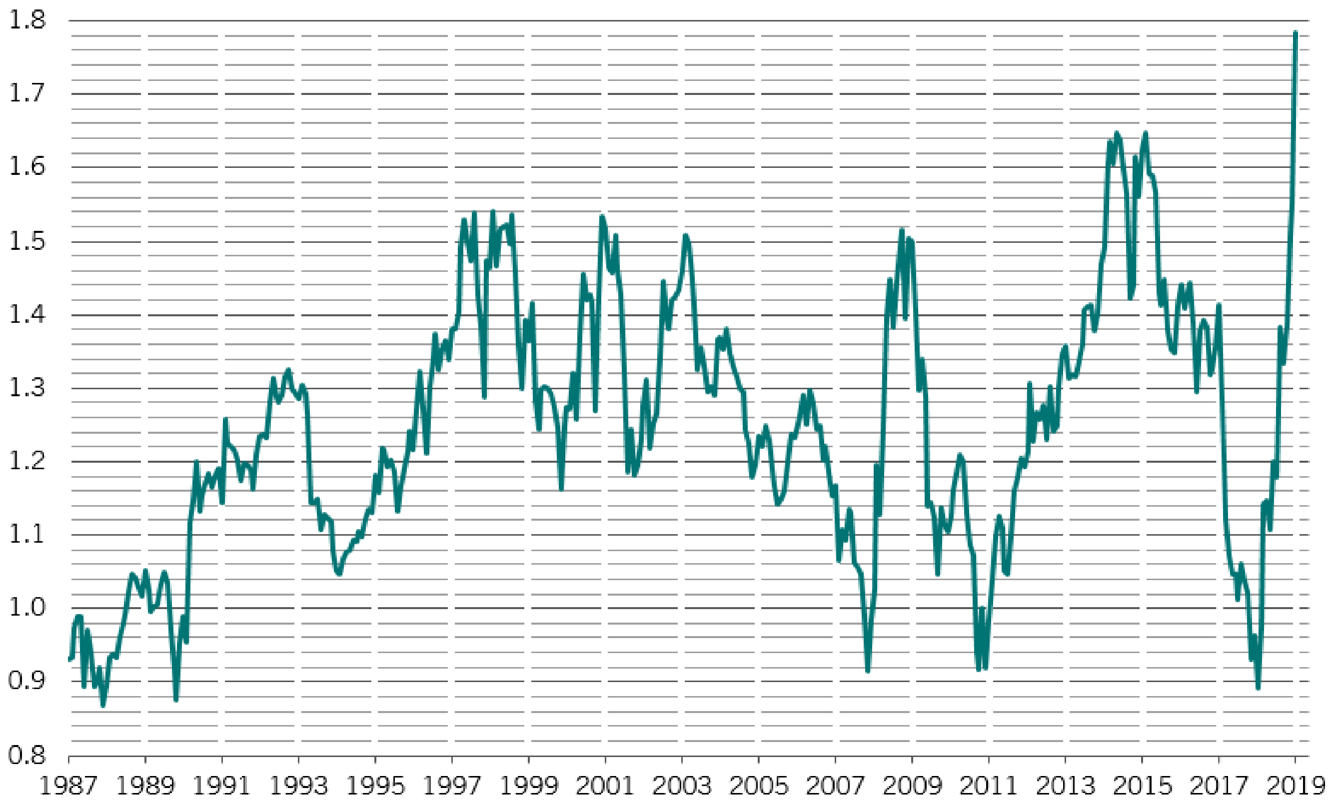
Conversely, we are underweight the consumer discretionary sector. Not only is it the most expensive according to our valuation model, but it is also likely to be the most negatively affected by the coronavirus fallout. Businesses within China will be particularly hard hit, not least as quarantines and fear of infection force people to stay at home. There will also be a broader fallout: fewer Chinese tourists staying in hotels and buying luxury goods in other countries. (Chinese consumers account for a third of the global personal luxury goods market, according to data from the consultant McKinsey).

Separately, we remain attracted to UK stocks, with the investment case supported by a more stable political situation and the market's capacity to generate healthy levels of income – the FTSE 100 has a dividend yield of around 4.7 per cent, compared to 1.8 per cent for the S&P 500.

We also continue to prefer euro zone to US stocks. In the US, the equity risk premium – an estimate of how much return stocks provide over the risk-free rate – stands at 5.4 per cent, far lower than the German market's 8 per cent. Although the German economy has suffered from trade disputes in recent months, there are reasons for optimism. European consumption is solid, with retail sales growing at over 2 per cent, year-on-year and mortgage growth hitting new highs. German sentiment has improved too; if hard data follows suit, as we expect, European equity markets should benefit.

Fig. 3 US stocks' lofty valuations

MSCI USA PEG ratio (12-month P/E divided by 3-5 years consensus EPS growth)



Source: Refinitv Datastream, IBES, MSCI, Pictet Asset Management. Data covering period 30.12.1987-30.12.2019.

In fact, the US looks expensive on virtually every measure. The US price-to-earnings growth (PEG) ratio (P/E divided by consensus earnings growth forecast) has rocketed over the past year to an all-time high. It is a shade under 1.8 compared to a long-term average of 1.25, which is nearly a four standard deviation move (see Fig. 3).

However, low valuations are not the only consideration in investment decisions, and in the case of the US we see grounds to remain neutral rather than negative. For a start, there is a chance that the economy could regain strength. Housing activity is picking up, fuelled by declining mortgage rates and we are encouraged by early signs of a recovery in non-residential investment. Secondly, the Fed remains very supportive. And thirdly, while the quarterly earnings season so far has shown lower profits, the majority of companies have managed to beat – admittedly downgraded – analysts' expectations.

03
Fixed income and currencies: taking some hedges

While we are optimistic about the global economy over the medium run, we are more cautious about its prospects over the short term. This is why we continue to hold several defensive assets.

For example, we remain overweight gold. It traditionally offers protection against the possibility of an economic dip. What is more, the precious metal should also draw support from low real interest rates; the price of gold tends to rise whenever real rates fall. In the US, the five-year government bond yield adjusted for inflation is flirting with a seven-year low of around -0.7 per cent. We also retain a higher than average exposure to the Swiss franc - a currency that usually appreciates whenever economic conditions deteriorate.

Adding to our defensive hedges, we retain an allocation to US Treasuries – which provide additional insurance against the economic fallout from the coronavirus outbreak.

These defensive positions are largely tactical. Over the medium term, we expect some riskier areas of the fixed income market to fare well. Such as emerging market bonds.

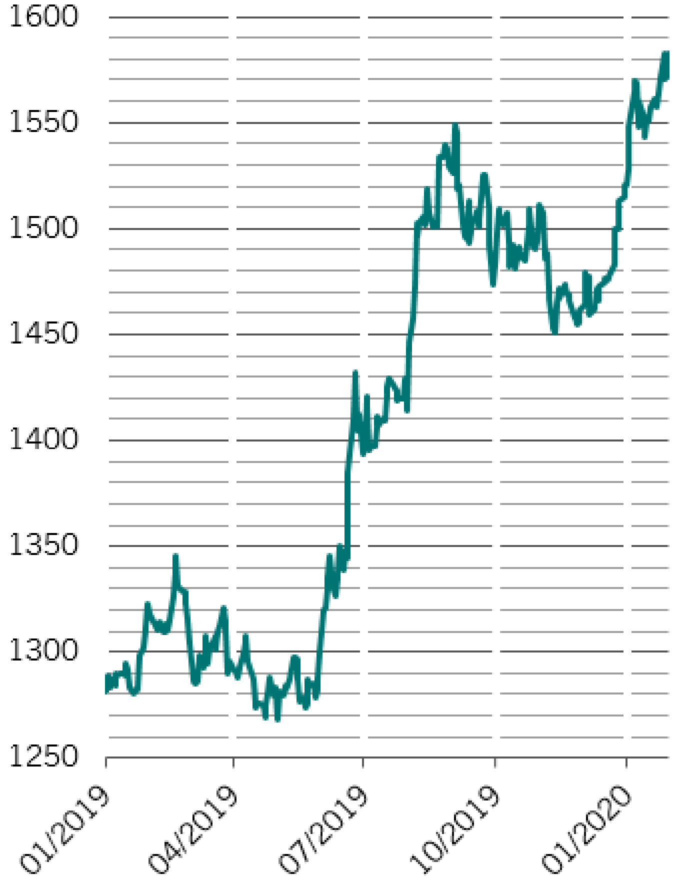
Not only do EM assets boast attractive yields, but EM currencies are also undervalued by up to 25 per cent, according to our model.

The currency recovery we envisage should provide a key source of return for local currency EM bond investor – currency appreciation has accounted for as much as a quarter of the asset class’s total return in the past decade.

Chinese onshore bonds look especially appealing.

They are likely to attract inflows as the asset class is to be included within the flagship JP Morgan GBI-EM index from later this month – testifying to the internationalisation of the world's second largest bond market. Chinese RMB-denominated bonds will be phased into the benchmark index over a 10-month period until they reach the index cap of 10 per cent.

Fig. 4 All that glitters
Gold Bullion USD per troy ounce



Source: Refinitiv, data covering period 01.01.2019 - 30.01.2020

We continue to steer clear of developed market credit. After posting double digit gains in 2019, the asset class is likely to struggle this year, with yield spreads already widening as much as 50 basis points from their 2018 lows. The US yield curve suggests that the default rate in the riskier parts of the corporate bond market is likely to double over the next five years to near 6 per cent.

In the foreign exchange market, one of our long-term convictions is for the dollar to weaken. Among developed market currencies, we think sterling has the potential to rise the most against the greenback as it remains one of the most undervalued currencies.

04

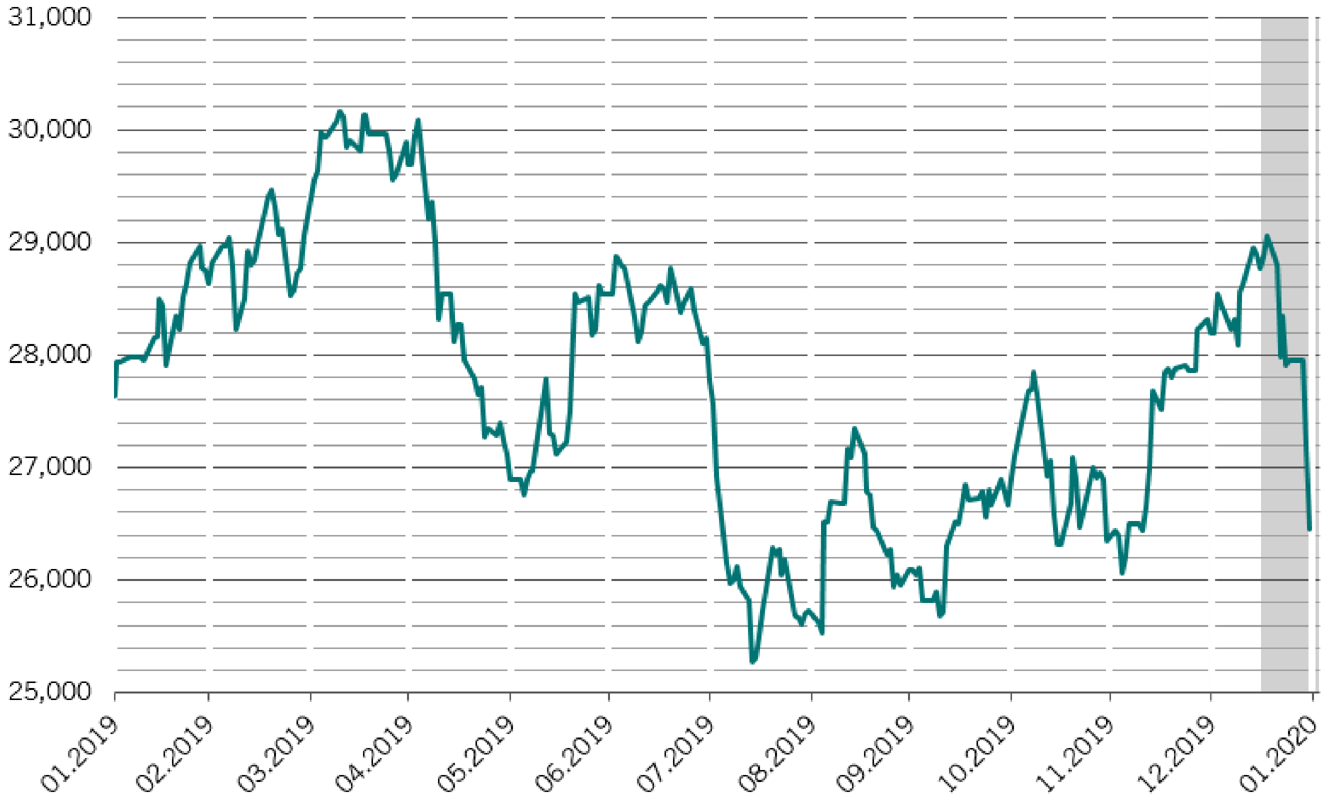
Global markets overview: stocks suffer

Equities had a volatile start to the year. The MSCI All Country World Index climbed to record highs before turning tail to finish the month in the red. Sentiment was hit by news of the coronavirus spreading across China and beyond.

China's stock market was shut for an extended Lunar new year holiday in the final week of January, but Hong Kong's Hang Seng Index lost over 5 per cent in just two days, dropping to near two month lows (see Fig. 5). Emerging markets more broadly finished January some 3 per cent lower in local currency terms.

Fig. 5 Coronavirus effect

Hong Kong equities – Hang Seng price index



Source: Refinitiv Datastream. Data covering period 30.01.2019-30.01.2020.

US stocks also saw a late month retreat, but managed to just stay in the black. Of the 226 S&P 500 companies who have already reported fourth quarter results, 69.5 per cent managed to beat earnings forecasts, according to Refinitiv Lipper Alpha Insight data.

Among global sectors, energy stocks suffered the most, down some 8 per cent in local currency terms as the price of oil fell 13 per cent. Materials and commodities were also hit. In contrast, technology and utilities managed to secure solid gains.

Fixed income markets benefited from investor uncertainty, with developed market government bonds doing particularly well. US Treasuries returned more than 2 per cent in January.

The dollar also had a good month, gaining 1 per cent against a trade-weighted basket of currencies. Emerging market currencies, such as the South African rand, were particularly hard hit as investors fretted about the spread of the coronavirus and its economic fallout. The Australian dollar was also badly affected, falling almost 5 per cent towards levels not seen for a decade.

In contrast, gold benefited from safehaven flows, gaining some 4 per cent.

05

In brief

BAROMETER FEBRUARY 2020

Asset allocation

We raise our bonds allocation to neutral from underweight and remain neutral on equities.

Equities regions and sectors

We see attractive value in UK equities and in the global financials sector.

Fixed income and currencies

We like US Treasuries and emerging market local currency debt.

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