PICTET
Asset Management

ASSET ALLOCATION

MONTHLY INVESTMENT OUTLOOK

Change is in the air

Barometer

May 2018

Pictet Asset Management Strategy Unit

A peak in economic growth improves the outlook for bonds, but it may be too soon to call time on the equities rally.

Table of contents

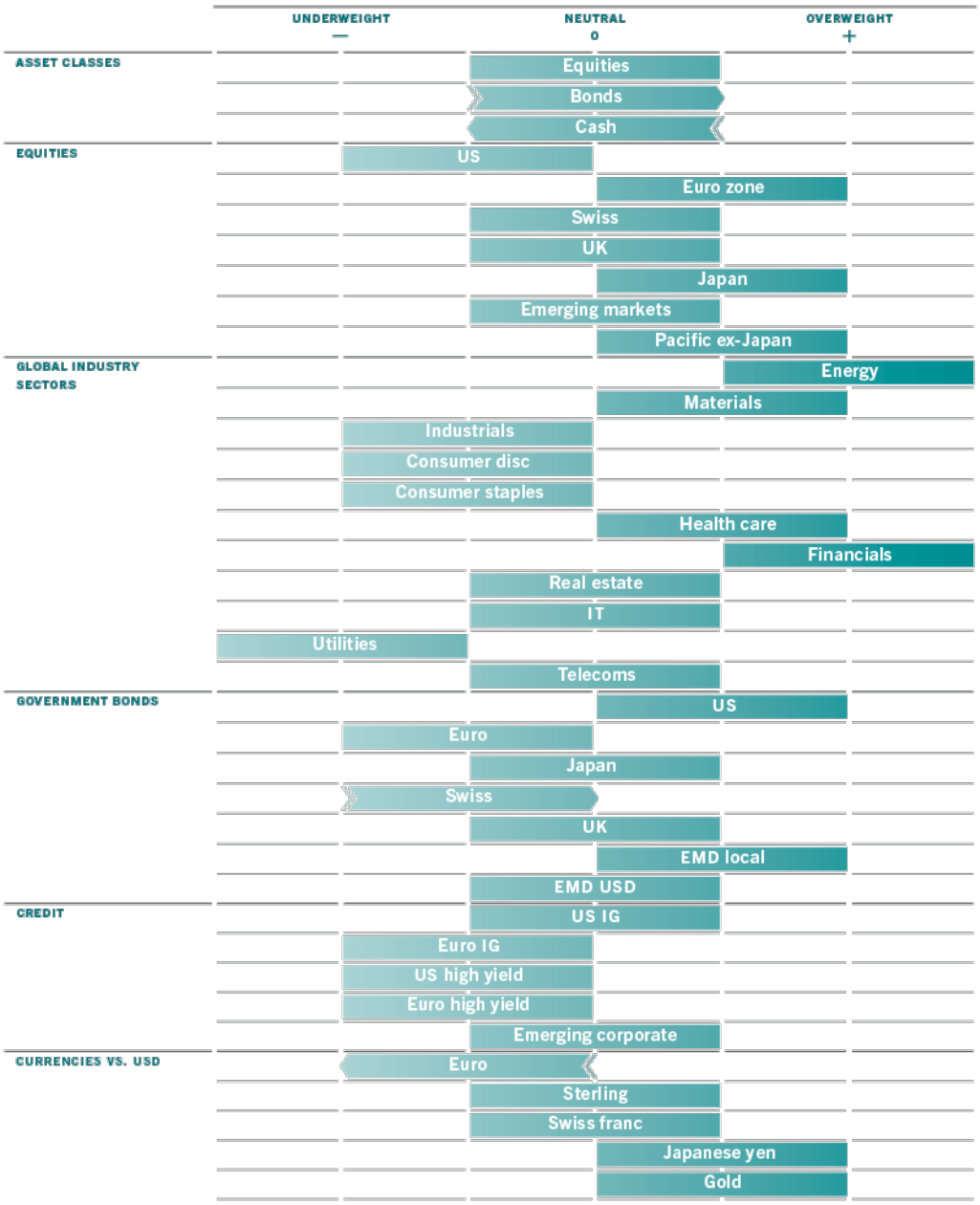
01

Asset allocation: shifting into neutral for global bonds

For the world economy, it is no longer full steam ahead: our **business cycle** analysis suggests that growth has peaked. That doesn't necessarily mean a slowdown – much less a recession – is around the corner. In fact, we expect growth will remain resilient, holding at around its long-term trend levels over the next five years.

However, it does signal a shift in gear, and it won't be long before financial markets start to adjust accordingly. As the first step of that adjustment, we have dialed our positions back to neutral across the board. This has meant upgrading bonds, downgrading cash and leaving equity allocation unchanged from last month.

MONTHLY ASSET ALLOCATION GRID
May 2018



Source: Pictet Asset Management

With our global leading indicator falling for the past five months in a row and the Citi Economic Surprise Index dipping into the red, bonds certainly look like a more attractive proposition – or at least a less unattractive one. Positioning is also potentially supportive, with a near record 55 per cent of fund managers surveyed by the Bank Of America-Merrill Lynch underweight US government bonds.

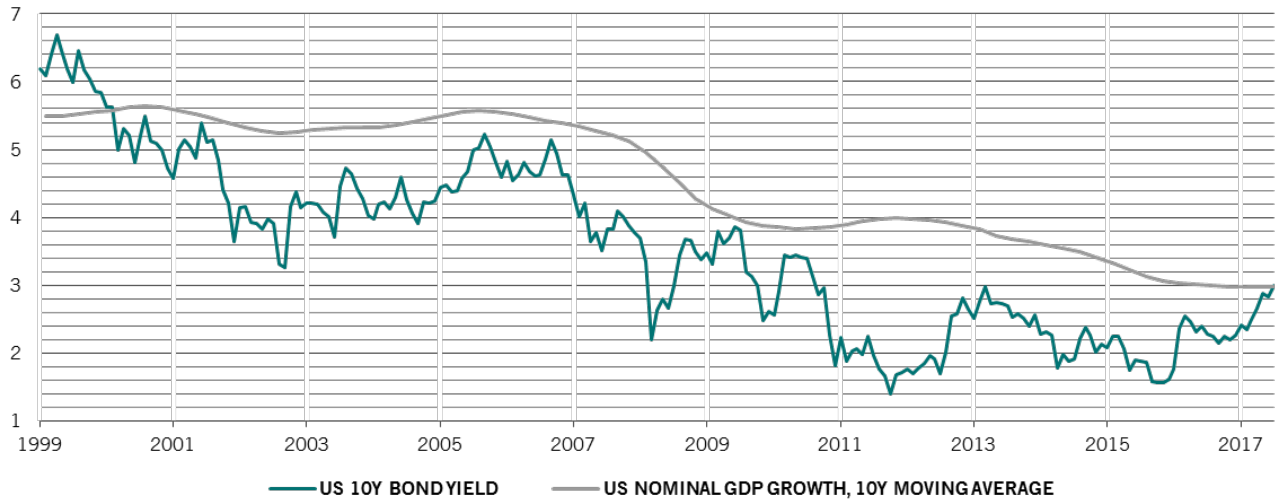
On the face of it, central bank policy offers a further argument in favour of fixed income. Our global **liquidity** gauge points to a tightening in monetary conditions. However, the slowing growth could give policymakers pause for thought.

While we think that the weakness in the first quarter is an "air pocket" in an environment of solid growth, a second quarter of sub-par data may prompt the US Federal Reserve to slow down the pace of its tightening compared to the two to three hikes currently priced in by markets. It may also encourage China into launching new stimulus measures.

Valuations, too, do not offer a compelling "buy" signal for equities nor bonds. True, benchmark 10-year US Treasury yields have breached the landmark **3 per cent yield** level for the first time since 2014 (see chart). But, in aggregate, bonds remain expensive on our models: rising inflation, a tighter Fed and still solid growth would suggest an overshoot in yields is possible.

On balance, therefore, we see reason to upgrade bonds, but only by one notch: to neutral from underweight. That puts them on a par with our equity position.

TREASURY YIELD HITTING A CEILING?
US 10-year government bond yields and nominal GDP growth, %



Source: Thomson Reuters Datastream. Data covering period 24.10.1999 – 24.04.2018

While a correction here is likely over the medium term, we think it is too early to call the end to the bull market. Recent weakness has taken stock market valuations down to neutral levels, offering potential fresh entry points. Any sign of scaling back on the Fed's tightening plans could provide a catalyst for a final hurrah. **Technical** indicators broadly support our top level asset allocation, with neutral short-term sentiment readings for both bonds and equities.

02

Equity regions and sectors: lofty expectations baked in the US

Weaker economic growth and tighter monetary conditions are likely to combine to keep equities in a tight range in the coming months, although prospects for European markets and some cyclical stock sectors remain bright.

We see limited potential in US stocks, and hence remain underweight the region. US companies have reported stronger-than-expected results in the first quarter, but there are signs that earnings growth is slowing.

The ratio of US firms upgrading profit forecasts to those downgrading them has fallen to just 3 per cent over the past month from a record 22 per cent earlier this year.

Against this backdrop, investor expectations for earnings growth among S and P 500 firms this year look unrealistic at 20 per cent. Such projections look even less achievable considering they would require nominal US GDP growth of 6 per cent according to our calculations - a level last seen in 2005.

CYCLICALS AT A PREMIUM
P/E differential: cyclical vs defensive stocks, MSCI World Index

Cyclically-adjusted. Source: Thomson Reuters Datastream. Data covering period 21.04.2015 - 24.04.2018

Across the Atlantic, we keep our preference for euro zone stocks. The region's markets remain reasonably valued while business conditions – and corporate earnings - have room to improve further compared with the US. What is more, European companies are likely to benefit from a weaker euro – we see the currency depreciating in the coming months - and the low cost of capital. We expect the gap in the price-to-book value of the S and P 500 and the Stoxx Europe 600 indices, which stands at a record 85 per cent, to narrow in favour of European companies.

Elsewhere, despite our positive long-term outlook for emerging market stocks, we see short-term headwinds developing from a stronger dollar and stretched investor positioning. We therefore keep our neutral position in the EM region.

In terms of sectors, we continue to prefer energy stocks, which should draw strength from rising oil prices. We keep our underweight position in other defensive sectors, such as utilities and consumer staples, while maintaining our preference for some inexpensive cyclical sectors such as financials and materials. That said, the investment case for cyclical stocks has become less compelling, given that global cyclical stocks are now trading at a high 22 per cent premium on a cycle-adjusted basis over their defensive counterparts. In terms of market capitalisation, cyclical stocks have outperformed defensives by 40 per cent since July 2016 – the third strongest rally on record. We would consider increasing exposure to defensive stocks if weakness in global economic growth persists.

03

Fixed income and currencies: eyes on the T-bond

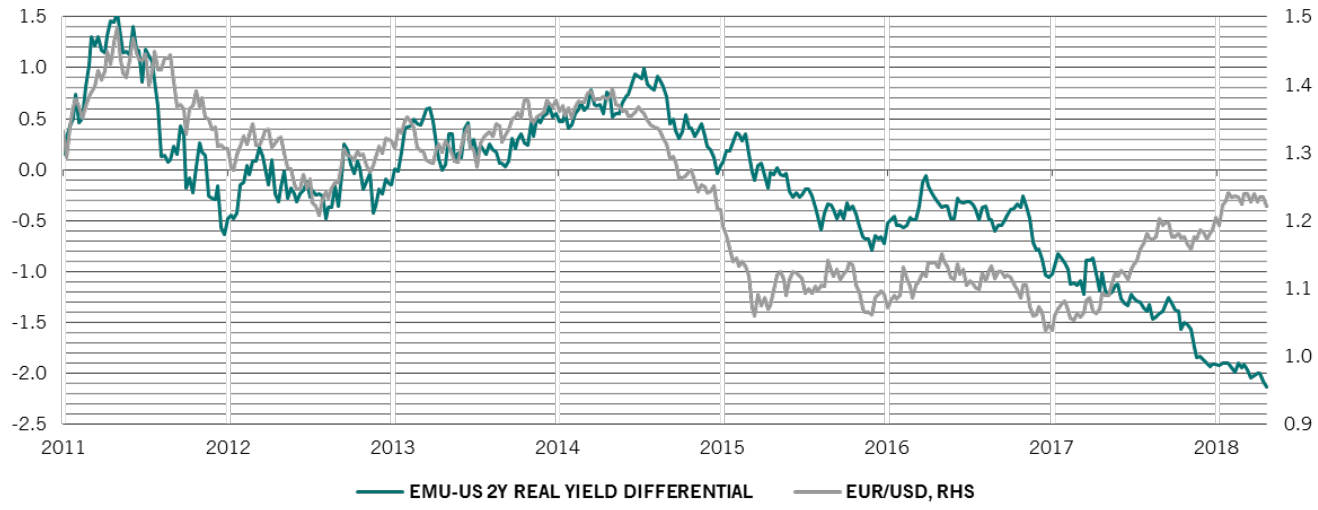
Having been underweight bonds for most of the past year, we have been prompted to lift our stance on the asset class to neutral by a steady rise in US 10-year Treasury bonds yields at a time when our leading indicators raise questions about global growth prospects.

That's not to say we expect economies to roll over – just that the gap between hitherto very bullish sentiment surveys and more moderate underlying economic data has started to close. This could be a sign that the two are coming back into synch again. Or, alternatively, that growth has peaked.

If the latter is the case, then there's reason to expect the Fed to rethink the pace of its tightening cycle – and the policy threshold for it to slow the rate at which it hikes the cost of borrowing is lower than to alter the timing and scale of its balance sheet reduction. The rise of US 10-year Treasury bonds yields above 3 per cent for the first time since 2014 – driven by a strong US jobs market, rising wages, buoyant inflation as well as technical factors like US government supply and the Fed's unwinding of its balance sheet – is already starting to be felt by some interest-rate sensitive sectors of the economy. The US government's fiscal spending programme is likely to mitigate some of the Fed's tightening, but won't reverse it entirely. If the Fed does recalibrate the pace of its tightening, we think the five-year part of the Treasury curve is most compelling.

It's also worth remembering that short-term movements in the US 10-year Treasury bond are less correlated with US economic activity – which is still robust – than with the state of the wider global economy, which is softer.

MIND THE GAP: LOSING YIELD SUPPORT, EURO TO WEAKEN VS DOLLAR
Euro zone and US 2-year bond yield differentials vs euro-dollar exchange rate



Source: Thomson Reuters Datastream, Pictet Asset Management. Data covering period 04.01.2011 to 24.04.2018

Within the universe of sovereign debt, we have moderated our underweight stance on Swiss government bonds, in line with our position on euro zone government debt as both face similar fundamentals.

The best value in the fixed income remains emerging market local currency debt followed by US Treasury bonds.

On currencies, we have cut our euro position to underweight from neutral amid our view that the dollar is set to rally further. That's because we think interest rate differentials will continue to favour the US currency. The 10 year inflation protected US Treasury bond yield is at 0.85 per cent, near the top of its five-year range. By contrast real yields in the euro zone are becoming increasingly negative as inflation ticks up in the single currency region. What's more, data suggest that speculative investors have driven the market to become very long the euro against the dollar.

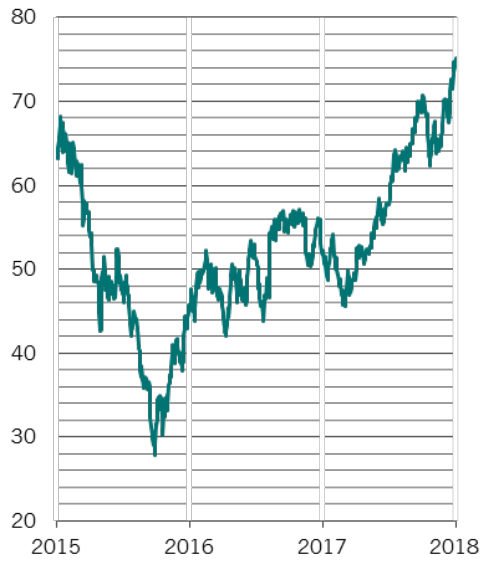
04

Global markets overview: stocks, oil rise

Equities extended their recovery from a sell-off earlier in the year as strong corporate results and big-ticket merger and acquisition deals lifted market sentiment. At a global level, companies have announced a record USD1.7 trillion in M and A deals this year, with mega deals accounting for over half of total value.[1]

Energy stocks were the biggest winner among sectors, rising over 9 per cent as oil prices hit a four-year high of USD75 a barrel on supply concerns and worries about geopolitical risks (see chart). Materials and utility stocks have also outperformed. In terms of regions, UK stocks were standout performers, rising nearly 7 per cent in local currency terms as a weaker pound outweighed persistent concerns about Brexit.

OIL RACES TO 3-YEAR HIGH
Brent oil price, USD/barrel



Source: Thomson Reuters Datastream. Data covering period 24.04.2015 - 24.04.2018

US stocks failed to benefit from a particularly strong earnings season, and ended the month nearly flat. Although first quarter S and P 500 earnings are seen growing at close to 25 percent, a seven-year high, investors seem to be discounting expectations that corporate earnings have already peaked.

Bonds ended the month lower as concerns about inflation pushed benchmark US Treasury yields above the psychologically important 3 per cent threshold. US and European high yield debt managed to end the month slightly higher. Emerging bonds were the biggest underperformer, with local debt falling 3 per cent, as a turnaround in the dollar and higher US yields weighed on investor morale. The Russian rouble fell nearly 9 per cent after the US imposed new sanctions against Moscow, targeting some of the country's biggest companies.

[1] Mega deals refer to deals with value, including net-debt, greater than USD5 billion. Source: Thomson Reuters Deals Intelligence, data as of 30.04.2018

05

In brief

BAROMETER MAY 2018

Asset allocation

We put all our top level allocations to neutral, which means upgrading bonds, downgrading cash and leaving equities unchanged.

Equity regions and sectors

US stocks still look unattractive. We keep our preference for Europe and Japan.

Fixed income and currencies

We cut the euro to underweight, and remain positive on US Treasuries despite recent price moves.