MULTI ASSET

MONTHLY ASSET ALLOCATION VIEWS

Steady as she goes

Barometer

September 2018

Pictet Asset Management Strategy Unit

The global economy remains resilient and corporate profits are healthy, despite trade tensions and wobbles in certain emerging markets.

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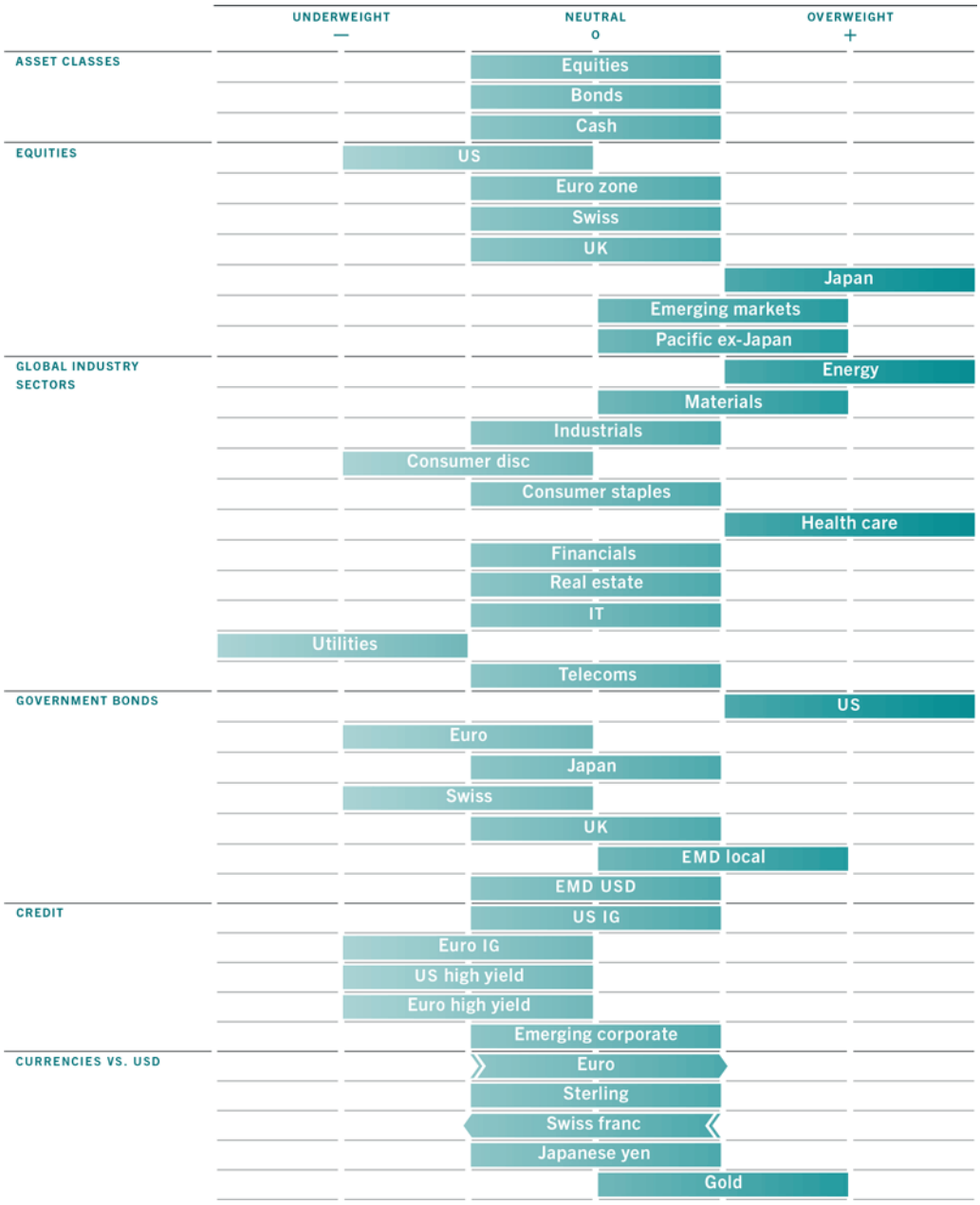
Asset allocation: risks evenly balanced

Investors heading into summer had no shortage of worries as escalating trade tensions threatened to hit corporate profits and derail the global economy at a time when major central banks were draining monetary stimulus.

However, their worst fears failed to materialise. The global economy remains resilient, supported by a buoyant US and euro zone, while companies worldwide continue to report healthy profits, even though their earnings growth may be plateauing. Monetary conditions also remain accommodative, with real interest rates in advanced economies standing at -0.9 per cent[1]. At the same time, the crises engulfing Turkey and Argentina have so far been largely contained, while monetary easing in China has helped stabilise the rest of the developing world, offsetting the impact of US import tariffs.

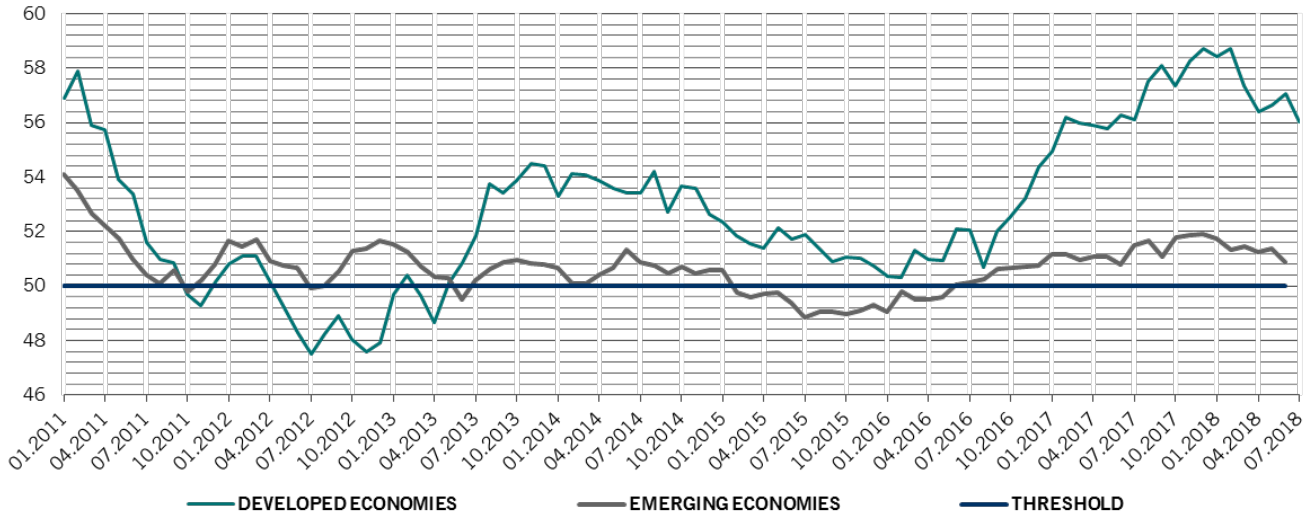
For all this, we feel it is too early to raise our allocation to equities from neutral to overweight or change our neutral stance on bonds – our liquidity and valuation indicators suggest caution is warranted.



Source: Pictet Asset Management

Our **business cycle** indicators suggest the world economy is on track to grow 3.5 per cent, above its potential. Our global leading indicator has risen for the second month in a row, although it is still below the three-year moving average. Manufacturing sentiment in both developed and emerging economies has remained in “expansion” territory, although it has fallen from the peak seen earlier this year, reflecting some impact from trade tensions (see chart).

STILL EXPANDING
Purchasing Managers Survey for developed and emerging economies



Source: Pictet Asset Management, CEIC, Thomson Reuters Datastream, IHS Markit. Data as of 28.08.2018.

The US economy seems to be reaccelerating, supported by robust private consumption and labour market conditions. The only area of softness is in the housing market, which appears sensitive to changes in the cost of borrowing.

We still expect the US Federal Reserve to raise interest rates twice more this year, which would take the benchmark rate towards what is considered to be a neutral territory – neither expansionary nor stimulative. Beyond this point, however, we're not convinced the Fed will carry on hiking.

Economic conditions in the euro zone are stabilising, where falling unemployment and improving sentiment are supporting consumption.

More substantial improvements can be seen in China, where our leading indicator hit its highest in at least two years thanks in part to stronger construction activity. A fall in the yuan – its trade-weighted basket is 1-2 per cent below its central parity – has helped support the country's exports despite ongoing trade rows with the US.

Our **liquidity** readings remain neutral, supporting our stance on both bonds and equities. The People's Bank of China's monetary easing has lifted the country's total liquidity flow to 6.3 per cent of GDP, near its 10-year average, from 4.9 per cent[2]. This has helped offset tighter liquidity conditions in the US. While we don't expect the PBOC to abandon its campaign of reducing private sector debt, the stimulus should help support Chinese growth for the time being.

Valuation metrics are also neutral for equities overall although this masks major divergence between regions and sectors. The US remains the most expensive region and US companies are unlikely to repeat their blockbuster earnings performance of the second quarter. And, as we expected, we have seen the beginning of an investor rotation away from cyclical stocks into defensive ones – the premium at which cyclical stocks trade over their defensive counterparts now stands at 23 per cent on a cyclically-adjusted price-earnings basis, down from a record 30 per cent but still far above the long-term average of 10 per cent.

Technical gauges have improved slightly for equities, especially for defensive sectors such as healthcare. Encouragingly for stock investors, the rally in the equity market has broadened, with a greater number of industry sectors participating in it. The technical picture for emerging market (EM) stocks is also improving. The gauges we monitor show that flows out of EM assets are slowing even if the Turkish lira crisis led to outflows of USD1.4 billion in the week to August 15, according to the Institute of International Finance.

[1] CPI deflated, GDP weighted average of 7 nominal rates (policy rates, 3-month interest rates, 2Y, 5Y and 10Y swap rates, 5Y and 10Y government bond yields) for 10 developed markets

[2] Total liquidity flow is calculated as the combination of policy and private liquidity flows over preceding 6 months as percentage of nominal GDP

02

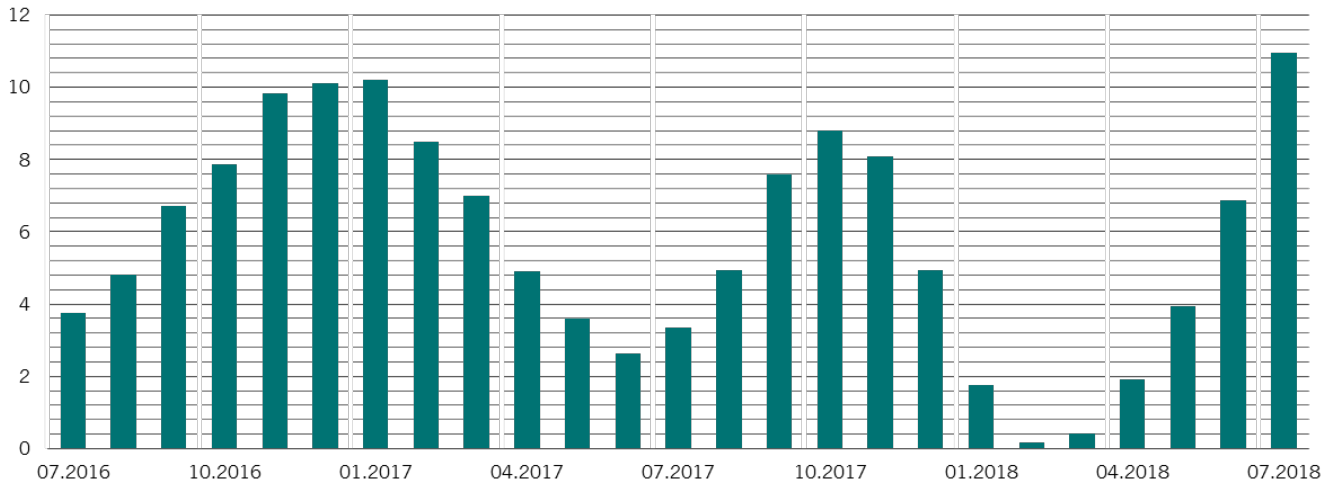
Equity regions and sectors: EM flashes green

The US's deepening trade dispute with China presents a risk for the developing world's exporters while the US dollar's ascent threatens to unleash inflation and cause problems for EM firms with liabilities denominated in the greenback. Turkey's currency crisis and its diplomatic overtures towards Russia and Iran have further complicated matters.

This has not been lost on investors: their retrenchment from the asset class has pushed the EM equity market down some 17 per cent in dollar terms from the peak it reached in mid-January this year.

But there are reasons to believe the sell-off has run its course. To begin with, China has once again turned on the monetary taps in a bid to offset the effects of US import tariffs. This stimulus could, in turn, be supplemented by an expansion in public spending, which would add further momentum to economic growth (see chart) – a prospect that EM stocks have yet to factor in.

ECONOMIC CONDITIONS IMPROVING IN CHINA
Pictet Asset Management China Leading Index, % change, annualised 3m/3m



Source: Pictet Asset Management. Data covering period 30.06.2016-31.07.2018.

Another positive is that the US dollar's ascent is unlikely to endure for much longer. Our technical indicators – which include the currency positions of speculative investors – indicate the greenback is now 'overbought' and vulnerable to a correction.

Valuations are also a plus. Following the recent sell-off, EM stocks are now trading at a 25 per cent discount to their US counterparts on a price-earnings basis, more than 10 percentage points cheaper than the historical average.

That looks excessive, particularly as analysts' expectations for EM corporate earnings growth for both this year and next have remained more or less steady at 18 per cent and 11 per cent, respectively.

For these reasons, we remain overweight EM stocks.

We are far less enthusiastic about European and US equities. US stocks in particular don't look good value: although US corporate profits continue to beat expectations, earnings growth is slowing quarter on quarter, albeit slightly.

What is more, consensus expectations for US earnings for 2019 discount a profit rise in the order of 10 per cent. That would require the economy to grow at a nominal 6 per cent annualised – an unlikely outcome given the length of the current expansion.

Our sector preferences remain unchanged from last month. While defensive equity sectors have fared better than their cyclical counterparts in recent weeks in a trend that could continue, we have decided against making any further reductions in our exposure to economically-sensitive stocks. That said, we remain underweight consumer discretionary stocks, which remain expensive relative to their average valuations and compared with other sectors.

03

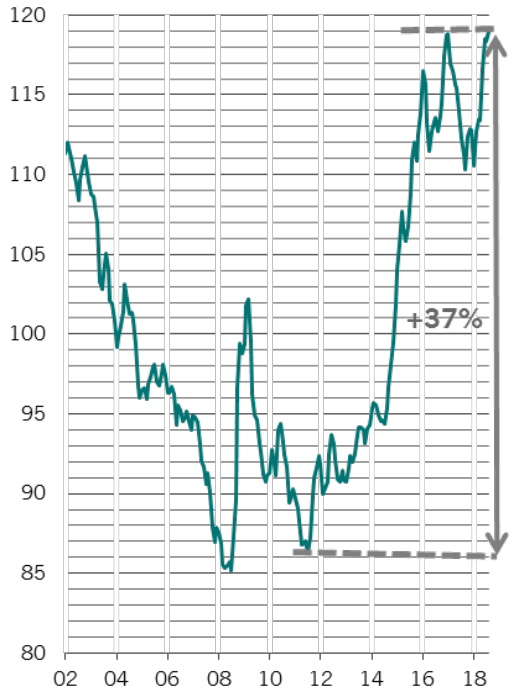
Fixed income and currencies: questioning the dollar

Ever since it started clambering out of its post-financial crisis doldrums, the US dollar has been on a largely one way trip. On a trade-weighted basis, it has gained 37 per cent since July 2011.That's left it about as richly valued as it's been in for at least a quarter of a century (see chart). The dollar's strength is underpinned by a robust US economy, rising inflation and expansive fiscal policy, which have prompted the Fed to take the vanguard in reversing the emergency monetary accommodation of the past decade.

But we feel that the greenback's ascent may have run its course. Unless there's an inflationary surprise or President Donald Trump's administration offers up another round of tax cuts, the prospects for further dollar gains are likely to be limited.

As a result, we have raised our stance on the euro-dollar exchange rate to neutral from underweight. At the same time, however, we've decided to minimise exposure to prospective currency volatility by also reducing our position on the Swiss franc to neutral from overweight.

UP, UP AND AWAY
Trade-weighted US dollar, Jan 2000 = 100



Source: Pictet Asset Management, CEIC, Thomson Reuters Datastream, Bloomberg. Data covering period 01.01.2002 - 29.08.2018.

Notwithstanding gold's recent weakness – which, in part, could have been driven by some emerging market central bank liquidations as they tried to defend their struggling currencies – we retain our overweight stance on the precious metal. What is more, our technical indicators suggest the market is net short gold, which is unprecedented. A weaker dollar should be good for emerging market local debt, on which we retain an overweight position. That's reinforced by the fact that EM local debt is the only fixed income class that is unequivocally cheap – largely thanks to weak EM currencies. According to our valuation metrics, EM currencies are the cheapest they've been relative to the dollar for at least 20 years on a purchasing power parity basis.

We also remain overweight on US Treasury bonds as a hedge against global market volatility and because they are less expensive than other bond markets. With the spread between 10-year and 2-year Treasury yields back to 18 basis points, their lowest level since July 2007, a growing number of market participants are worried about the US economy's medium term prospects – historically an **inverted yield curve** has signalled recession down the road.

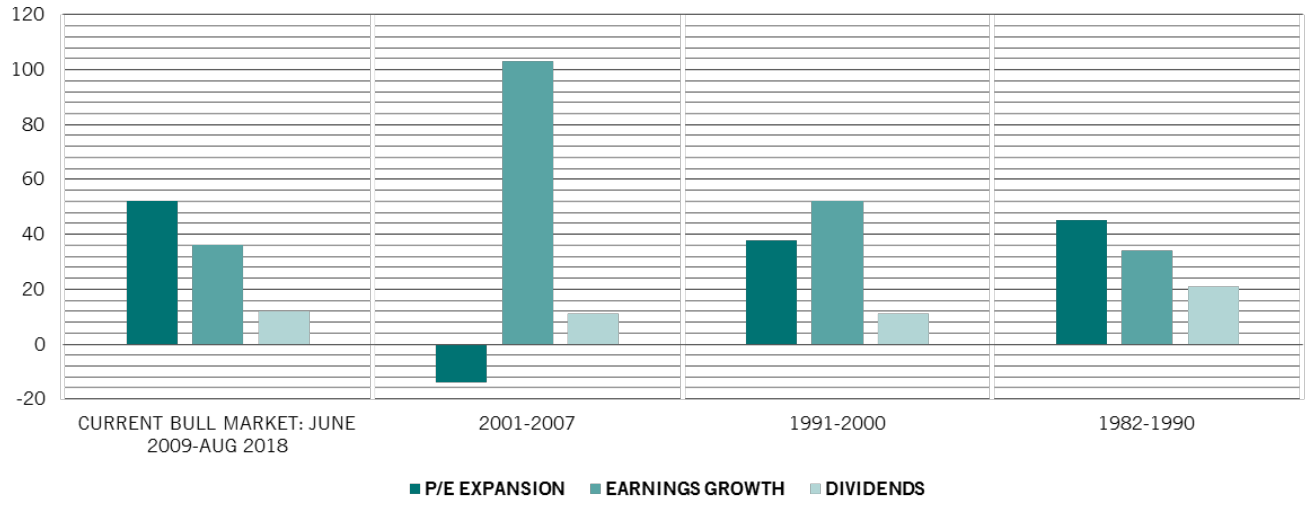
At the same time, we are cautious on credit. Valuations are too high, while corporate leverage is rising – it's at 20-year highs for half of the non-financial sectors for global equities – and creditor covenants are weakening in the primary bond market.

04

Global markets: US stocks in the lead

Equities finished summer on a high, adding 1.2 per cent in August in local currency terms. On a regional basis, US delivered the best performance, adding 3.3 per cent as companies reaped the benefits of tax cuts and delivered a strong set of quarterly results. Earnings at nearly 80 per cent of S&P 500 companies beat expectations, according to Thomson Reuters Lipper Alpha Insight. The current bull run in US stocks, which started back in June 2009, is now the longest in history, in part reflecting an unusually protracted period of economic growth and QE. While earnings growth has been an important contributor, the expansion in price-to-earnings ratios has played an even bigger part (see chart).

US EQUITY BULL RUNS
Bull markets in S&P 500 index, contribution by factor, %



Source: Pictet Asset Management, Thomson Reuters Datastream. Data as of 28.08.2018.

In contrast, European equities – across the euro zone, UK and Switzerland – weakened on the month. Global trade tensions played a part, with Europe being home to some of the world's biggest exporters. Earnings have also been weaker than across the Atlantic, with only around half of the STOXX 600 companies that have reported second quarter numbers bearing expectations.

Among global sectors, consumer discretionary, healthcare and technology fared the best in August. Energy and materials companies, meanwhile, finished the month in the red despite strong gains in both oil and commodity prices. Oil added 4.3 per cent, partly reflecting falling supply from Venezuela and upcoming US sanctions on Iran.

Global fixed income was broadly flat on the month. Modest gains in some developed market government bonds were counterbalanced by a sharp sell-off in emerging markets, where local currency debt lost over 6 per cent. US sanctions weighed on sentiment on both Russia and Turkey, Brazil was hurt by uncertainty ahead of October presidential elections and Argentina's currency crisis showed no signs of abating despite frantic interest rate hikes by the central bank. Continued expectations of Fed interest rate hikes also weighed on EM debt, while boosting the performance of US bonds across the spectrum – Treasuries, investment grade and high yield paper from the country all posted gains in August.

The dollar benefited from the emerging market rout, with particularly notable gains against the Argentine peso, Turkish lira, South African rand, Brazilian real and Russian rouble.

05

In brief

BAROMETER SEPTEMBER 2018

Asset allocation

We keep our neutral stance on equities and bonds as the global economy remains resilient despite risks from trade tensions

Equity regions and sectors

We remain overweight emerging market equities as risks are offset by attractive valuations and broadly solid fundamentals

Fixed income and currencies

We upgrade the euro to neutral, taking profit on our long USD position, and downgrade the Swiss franc to neutral

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