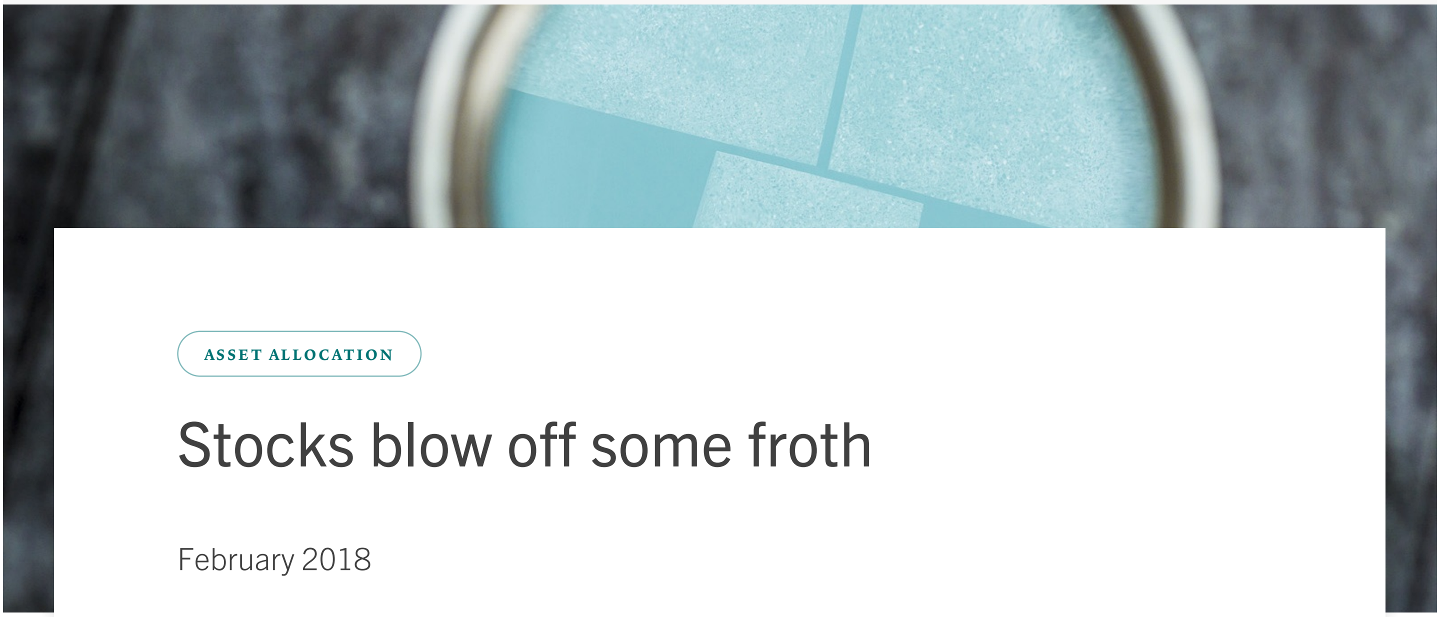
PICTET
Asset Management



ASSET ALLOCATION

Stocks blow off some froth

February 2018

Luca Paolini, Chief Strategist

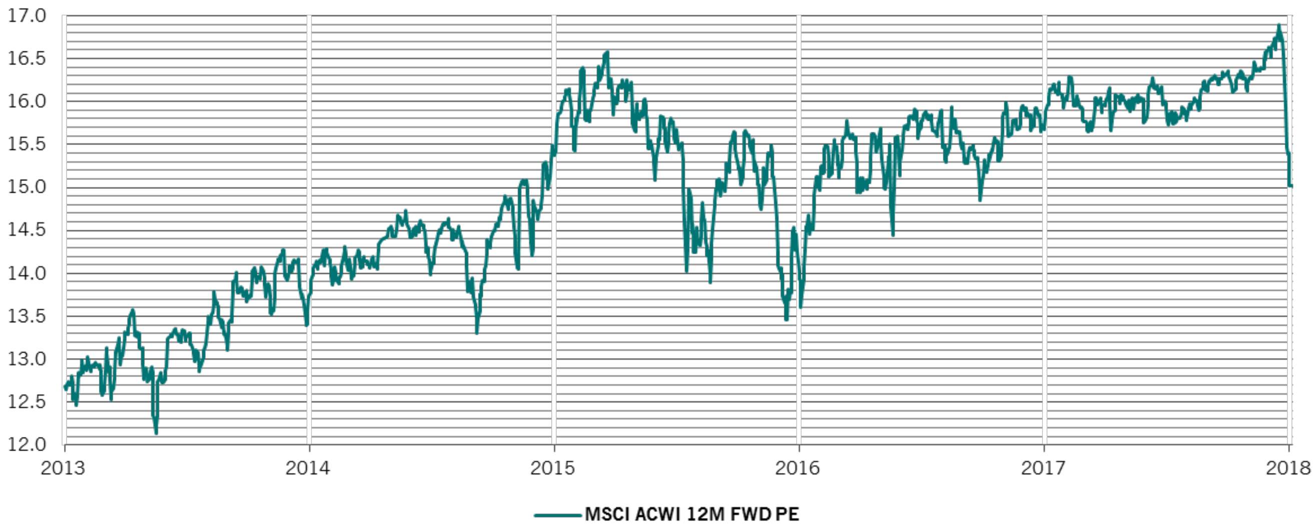
After the recent correction, global equity markets look set to extend their late cycle rally.

Last week's sharp drop in global stock markets may have been exactly what equity bulls needed. The correction, triggered by fears of a pick-up in the pace of inflation and amplified by technical factors such as the unwinding of short volatility bets, has taken the froth out of some of the most expensive markets, notably the US. This should allow equities to extend their late cycle rally by several months.

In the weeks before the market stumbled, our valuation and sentiment signals – two of the four factors we monitor alongside business cycle and liquidity gauges – were flashing red, which had made us cautious. For instance, the US equity market's valuation, measured by 12-month forward price to earnings ratio (P/E), had reached 18.8, the highest since the early 2000s.[1]

Fast forward one week, these signals have reversed. US equities' P/E is now a more reasonable 16.5, the same level of November 2016. The valuation of the MSCI All-Country Index has also dropped sharply (see chart). Investor sentiment readings have improved, too – indicating positions are far less bullish - after global equity funds saw outflows of USD30 billion for the week– a record.

MSCI All-Country World Index 12-month forward price to earnings ratio



Source: Thomson Reuters Datastream, 08.02.2013 - 12.02.2018

This is not to say equities should pick up from where they left off at the end of January. The global economy remains strong, but growth momentum may have peaked. Robust domestic demand and buoyant labour markets, especially in developed markets, should push inflation higher this year. We expect US core inflation to overshoot the Federal Reserve's 2 per cent target some time in 2018.[2]

This, in turn, raises the probability that central banks may be forced to scale back their monetary stimulus more aggressively than the economy can cope with.

[1] S and P 500 index
[2] Core PCE