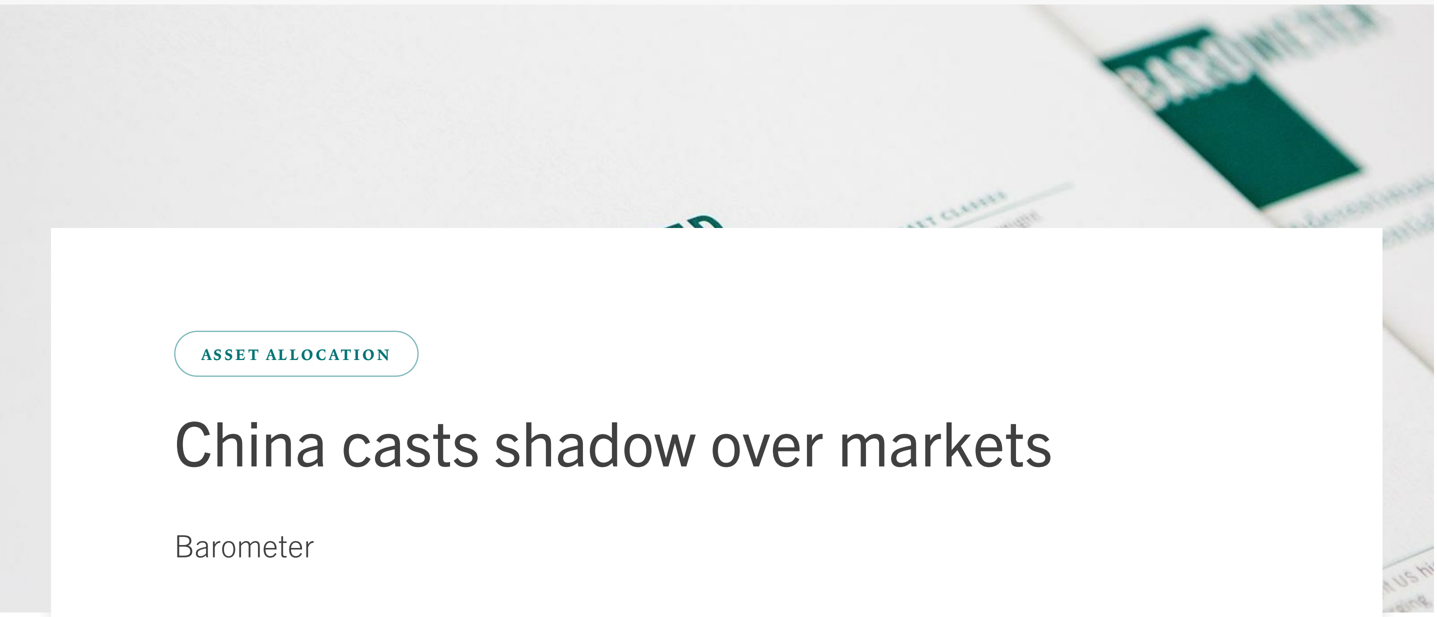
PICTET
Asset Management



ASSET ALLOCATION

China casts shadow over markets

Barometer

March 2018

Pictet Asset Management Strategy Unit

Although accelerating inflation in the US is worrying, a slowdown in China's economic growth should be investors' primary concern.

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Asset allocation: China's stumbles a cause for concern

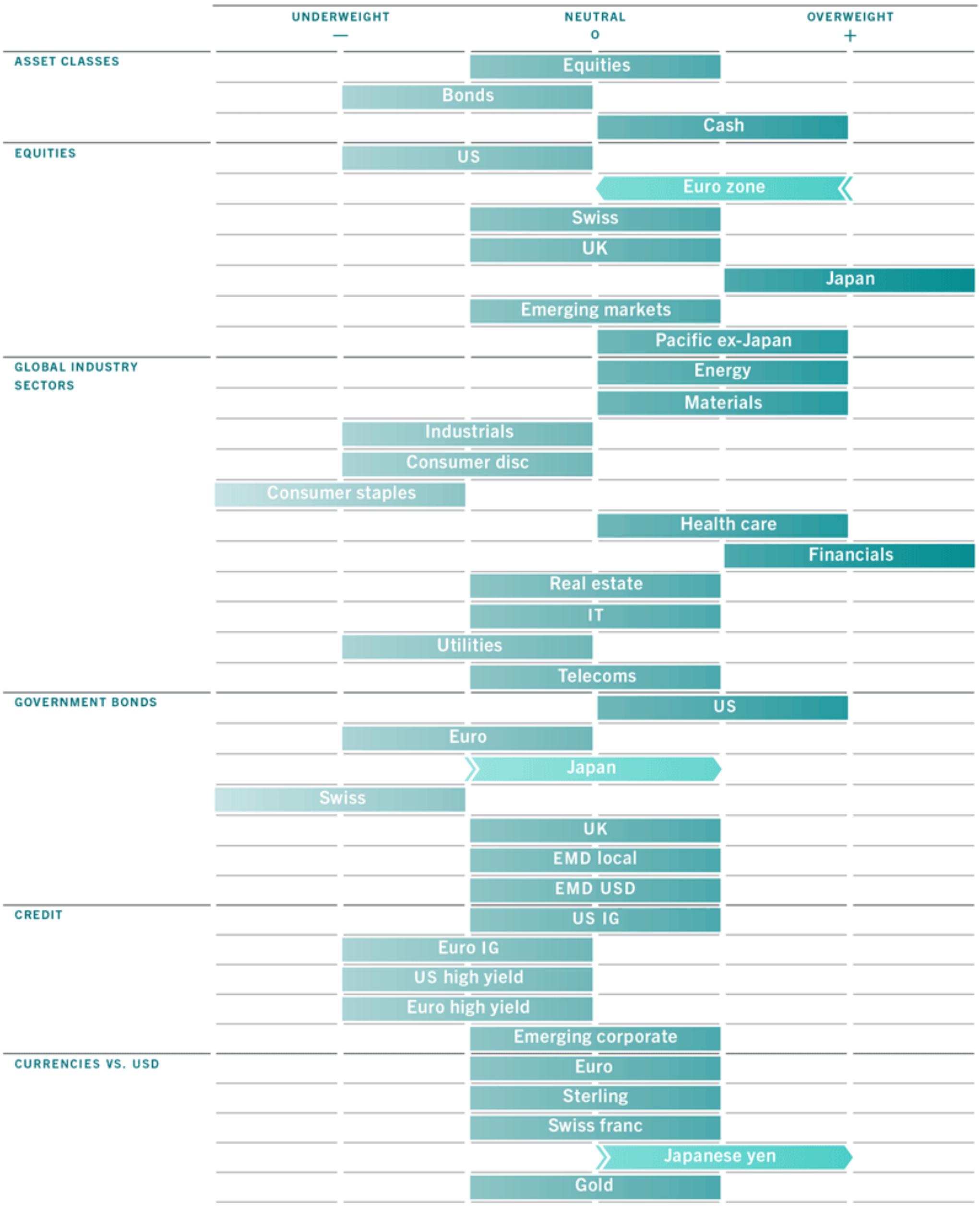
The **sell-off** that rattled global stock markets in early February has largely been blamed on signs the US economy could be overheating. That is still a risk, but it's not the main reason we find equities' near-term prospects uninspiring. Our primary concern is China. There, economic growth is slowing as authorities in Beijing make yet another attempt to deflate the country's credit bubble. So far, thanks to healthy demand for Chinese exports, the tightening of monetary policy has not done too much damage. But if, as seems likely, the pace of credit growth slows further and US President Donald Trump enacts additional protectionist measures against China, the prospects for emerging markets and the rest of the global economy will look less rosy than they did a few months ago.

Also likely to hold stocks back is a change in monetary conditions in the developed world. While an extreme example, China is not alone in reining in stimulus. In the US, new Federal Reserve Chairman Jay Powell used his first testimony before Congress to suggest that the pace of rate rises could quicken in 2018 as economic growth and inflation gather strength. The same looks likely in the UK. And while the Bank of Japan and the European Central Bank retain quantitative easing for now, both are certain to retrench later this year.

It's not all bad news for equity markets, however. More positively for stocks, the February sell-off has lowered price-earnings (P/E) multiples to fairer levels. Taking all this into account, we have opted to retain our neutral stance on equities.

Elsewhere, the draining of central bank stimulus threatens something more serious for the fixed income market. We remain underweight bonds, concerned that European markets in particular have yet to factor in the prospect of an end to ultra-easy money.

MONTHLY ASSET ALLOCATION GRID
March 2018



Source: Pictet Asset Management

Our **business cycle** indicators show the global economic expansion is slowing.

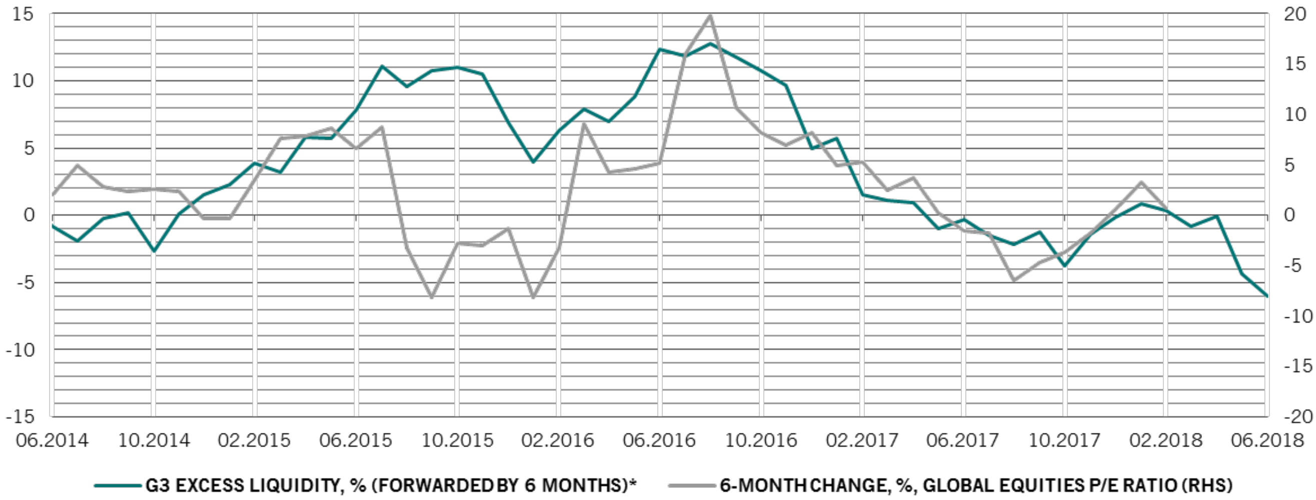
While the US remains in good shape – unemployment is close to its lowest since the 1960s and we expect output to expand 2.8 per cent this year versus a previous estimate of 2.6 per cent – China is heading in the opposite direction.

Activity in the country's manufacturing sector declined at its fastest pace since 2011 last month, according to the purchasing managers' index. Nor is this slowdown limited to China. Both our emerging market and global leading indicators have declined somewhat over the past two months, albeit from very healthy levels.

Our **liquidity**readings show that monetary stimulus is being steadily drained from the financial system. In our model, central bank policies are stimulative when money supply is growing at a faster rate than industrial production.[1] That differential, which we have found has a positive correlation with stocks' earnings multiples, is now at its narrowest in seven years, suggesting P/E ratios could contract by some 5 to 10 per cent over 2018 (see chart). That would counteract any potential acceleration in corporate profits.

LIQUIDITY SCARE?

Tighter liquidity conditions could weigh on stocks' earnings multiples



* G3 broad money minus value of domestic industrial production (volume producer price index) growth over the past 6 months (GDP-weighted). P/E data taken from MSCI World Index. Source: Thomson Reuters Datastream, data covering period 01.06.2014 - 28.02.2018.

The February sell-off has returned **valuations** for some equity and bond markets to fairer levels. But US stocks continue to command what we consider to be an excessive premium over European ones: the gap in their respective price-to-book ratios is now at its widest since 1993 (3.5 vs 1.7). The recent rise in bond yields, meanwhile, has given rise to attractive opportunities in longer-dated US government debt (see fixed income section).

Our **technical** indicators provide a neutral signal for equities but a clear "sell" signal for developed market bonds. Our readings on the US dollar, meanwhile, suggest the currency may be due a rebound. That's because professional investors have largely favoured setting up short positions in the dollar, an imbalance in positioning that limits the scope for further falls in the currency.

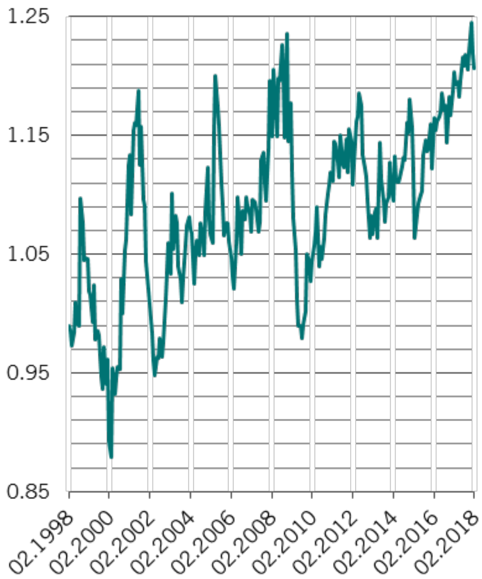
[1] Money supply growth and industrial production growth figures calculated for the US, Japan and the euro zone

02

Regions and sectors: US is cheaper but not a bargain

The storm that swept the markets in February helped blow some of the froth from equity valuations. Following the sell-off, the P/E ratio for US stocks has dropped to 17 times from 18.8 times at the end of January. However, just because the market is cheaper, it does not mean it is cheap or even good value.

US EQUITY VALUATION STILL HIGH
Ratio of 12-month forward P/E: MSCI US vs MSCI non-US



US 12-month forward price to earnings against the rest of the world. Source: Thomson Reuters Datastream. Data covering period 27.02.1998 - 27.02.2018

The US is still by far the most expensive of the major regions in the global equity market, according to our models. Indeed, relative to its own 20-year history, it offers worse value now than it did three months ago.

Even more worrying, this comes at a time when analyst forecasts for corporate profits appear overly optimistic. Consensus estimates show earnings rising by 19 per cent this year – a pace which our research shows has only ever occurred when the economy is growing at a nominal 5.9 per cent per year, which is a whopping 1.5 percentage points above the present rate. This is why we think that, bar a significant depreciation of the dollar, earnings growth is unlikely to offer positive surprises. And, based on recent market reactions, companies whose earnings disappoint could see their share prices punished hard. Add rising interest rates into the mix, and we think the case for an underweight position in US stocks remains very strong.

Elsewhere in the developed world, Japanese stocks look more attractive – not only compared to their US counterparts but also their European peers – in terms of both valuations and short-term growth prospects. While the Japanese economy continues to pick up pace, boosted in part by overseas demand for its exports. Europe's leading indicators – while robust – are starting to plateau. We believe this is at least partly a temporary trend, prompted by the fact that European business and consumer sentiment surveys have traditionally been more sensitive to spikes in market volatility, such as the one we saw at the start of this year. Nonetheless, we think there are sufficient grounds to trim our overweight in Europe.

Among sectors, we think cyclical stocks still have a bit further to run before higher bond yields and a turn in the economic cycle shift sentiment back in favour of defensive equities. Financials remain our top pick due to banks' ability to benefit from higher interest rates.

We see opportunities in energy and materials, and – on the defensive side – in healthcare. Conversely, we are cautious on consumer discretionary and industrials, the two most expensive sectors in our universe. We are also underweight two defensive sectors (utilities and consumer staples) that are not cheap enough and have poor earnings prospects due to falling margins. Such stocks also tend to suffer more than others when bond yields rise.

03

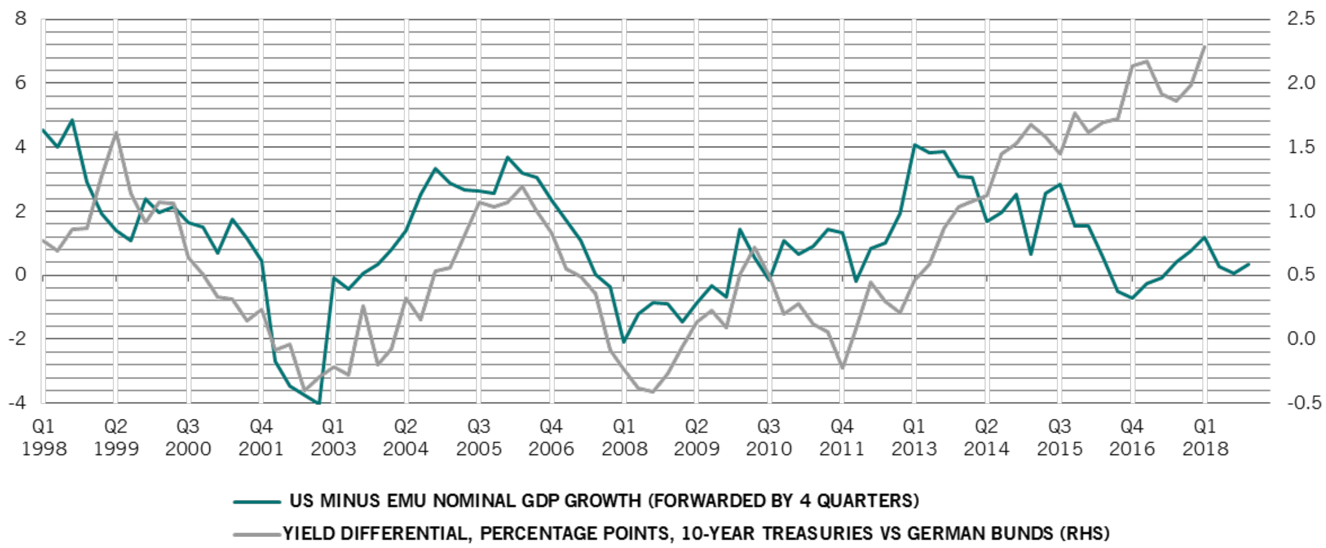
Fixed income and currencies: cracks in high yield widen

The cracks in the high yield bond market are starting to widen. **Growing inflationary pressures** and speculation that the Fed may accelerate the pace of interest rate hikes have spurred investors to reduce their holdings of speculative-grade debt in recent weeks. According to EPFR, more than USD10 billion was pulled from the high yield market in the week ending February 14, or some 2 per cent of its net assets – one of the biggest weekly withdrawals on record.

Despite this, the discount at which high yield debt trades to government bonds – the yield spread – has remained remarkably stable. To us, this suggests the sell-off has further to run. We see room for spreads to widen further as they have risen to only some 350 basis points, a level they last hit only two months ago.[1] Both US and European high-yield debt are still expensive in our valuation scorecard, which means they are particularly vulnerable to any further tightening of monetary policy.

NO LONGER JUSTIFIED BY FUNDAMENTALS

US yield premium over Germany is too high given Europe's healthy economic growth



Source: Thomson Reuters Datastream. Data covering period 31.03.1998 - 27.02.2018.

While high-yield bonds look expensive, the same can't be said of US Treasuries. Ten-year US government bonds now yield about 2.9 per cent, some 90 basis points above the 2017 low. It's a significant spike because it has reduced the differential between 10-year Treasury yields and the US nominal GDP growth rate to below 20 basis points, the lowest since 2010 – a sign that prices for US government bonds have adjusted sufficiently to reflect changes in the economic cycle.

That is a particularly strong 'buy' signal for longer-maturity debt. What is more, US government bonds are attractively-valued relative to their European peers. The yield spread between 10-year US and German bonds has risen to levels not seen in at least 20 years, a gap that looks hard to justify when there is no big difference in the growth rate of the two economies (see chart).

When it comes to currencies, we have increased our exposure to Japanese yen-denominated securities. The currency's tendency to appreciate in times of economic uncertainty makes it a good hedge against sudden bouts of market volatility such as the one we saw in early February.

[1] The Bloomberg Barclays High Yield Index

04

Global markets overview: equities wobble

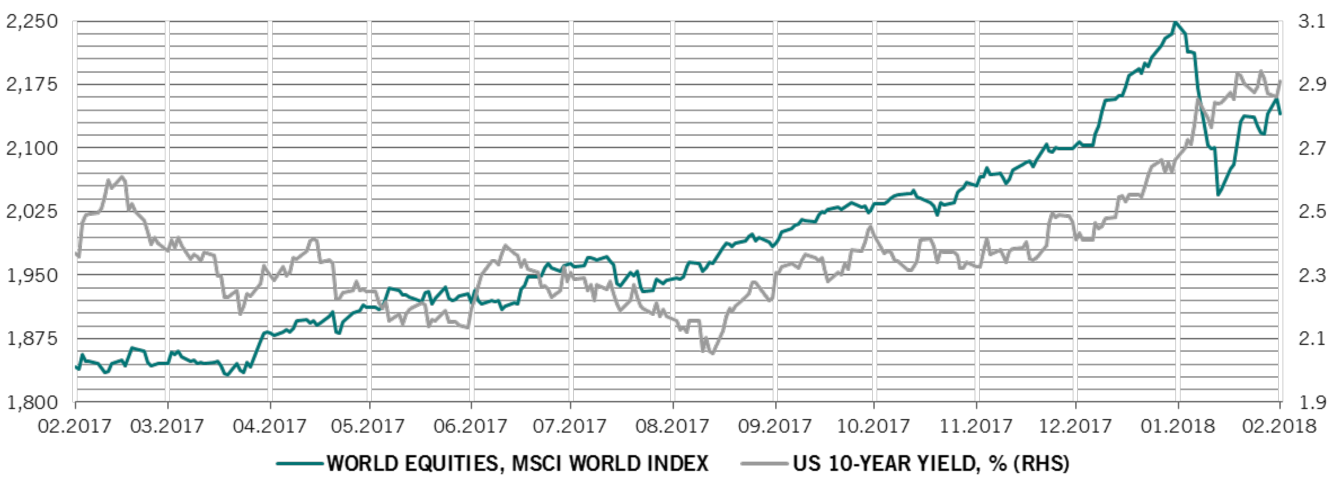
February could turn out to be the cruellest month for equities as all major stock markets were bathed in sea of red. The near-universal correction was triggered by fears that US inflation was starting to pick up and, as a consequence, that the Fed would tighten monetary policy more aggressively than previously thought. This also pushed US government bond prices lower, with the yield on the 10-year Treasury edging closer to 3.0 per cent, a level it has not hit since the end of 2013.

Losses were amplified by the sudden unwinding of positions that had been set up to profit from subdued market volatility – investors had become excessively complacent about the prospects for equity market stability.

The US and Japanese equity markets lost more than 3 per cent on the month in local currency terms, while euro zone stocks dropped marginally more. Swiss stocks were hard hit, losing close to 5 per cent. Emerging market stocks also suffered, down some 4 per cent, with emerging Asia registering the worst performance.

Among global sectors, energy – hit by slumping oil prices – and real estate took a particular pounding, each dropping by more than 6 per cent. IT was the best performer, managing to keep losses to a modest 1 per cent on the month.

SHARP CORRECTION: EQUITIES LOWER IN VOLATILE MONTH WHILE YIELDS RISE



Source: Thomson Reuters Datastream. Data covering period 27.02.2017 - 27.02.2018.

In fixed income, corporate credit held up reasonably well compared to equities. Euro zone investment grade and high yield bonds continue to be supported by the ECB's asset purchase programme. European corporate bond markets were largely flat on the month while high yield declined by less than 1 per cent. US equivalents were harder hit, however.

Similarly, sovereign bonds were relatively resilient, with only the US showing notable losses among developed markets, dropping close to 1 per cent on the month. Euro zone, Japanese and UK government bonds all picked up marginally in local terms, helped in part by their currencies' depreciation against the dollar. The greenback gained ground against most major currencies apart from the Japanese yen.

Emerging market local currency and dollar-denominated bonds suffered most after a long, strong run had left both markets looking expensive and vulnerable to a bounce in the dollar.

05

In Brief

MARCH 2018

Asset allocation

Question marks over China's economic prospects make us more cautious on the outlook for global equities.

Sectors and regions

We trim our overweight on Europe and remain cautious on US equities, despite the recent correction.

Fixed income and currencies

We remain underweight high yield debt, both in the US and Europe. We upgrade JGBs to neutral and raise the yen to overweight.

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