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## China fragility trumps US – Luca Paolini, Pictet Asset Management

Die Pictet Gruppe | 12. März 2018

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### London / Frankfurt, 12. März 2018

“The markets might be worried about a possible overheating of the US economy, but our biggest concern is China,” says Luca Paolini, chief strategist at Pictet Asset Management.

“Economic growth is slowing as the Beijing authorities try again 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.”

“Furthermore, if Trump does enact additional protectionist measures, the prospects for emerging markets and the rest of the global economy will look less rosy.”

“We have also trimmed our overweight in European equities and remain cautious on US equities, despite the recent correction.”

“Europe’s economic indicators are starting to plateau, perhaps temporarily given sentiment sensitivity to volatility such as we have just seen, but sufficient enough to suggest caution.”

“Despite the recent sell-off, US stocks offer even less value than three months ago, whilst consensus earnings estimates look overly optimistic.”

“It would take a significant depreciation of the dollar for earnings growth to offer positive surprises, and the US market has been punishing earnings underperformance hard.”

“Japanese stocks look more attractive relative to the US and Europe, both in terms of valuations and short-term growth prospects, with the

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Japanese economy continuing to pick up pace, boosted in part by export demand.”

“Among sectors, cyclical stocks still seem to 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.”

“Overall, we retain our neutral stance on equities and remain underweight in bonds.”

“Within fixed income, we continue with our underweight high yield debt stance in the US and Europe. We have upgraded JGBs and the yen.”

“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.”

“Despite this, the yield spread has remained remarkably stable in comparison suggesting that the sell-off could have further to run.”

“With 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. Significantly reduced bond buying by the Bank of Japan also puts upward pressure on the currency.”

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