

## BAROMETER

GLOBAL ASSET CLASSES  
We stick to our overweight



### ASSET ALLOCATION

#### MONTHLY GLOBAL ASSET ALLOCATION VIEWS

# Why it's not the end of La Dolce Vita for investors

Barometer

June 2018

Pictet Asset Management Strategy Unit

As markets become more volatile, it may be prudent to dial down cyclical exposure. But a solid world economy means there's no reason to run for cover.

## Table of contents

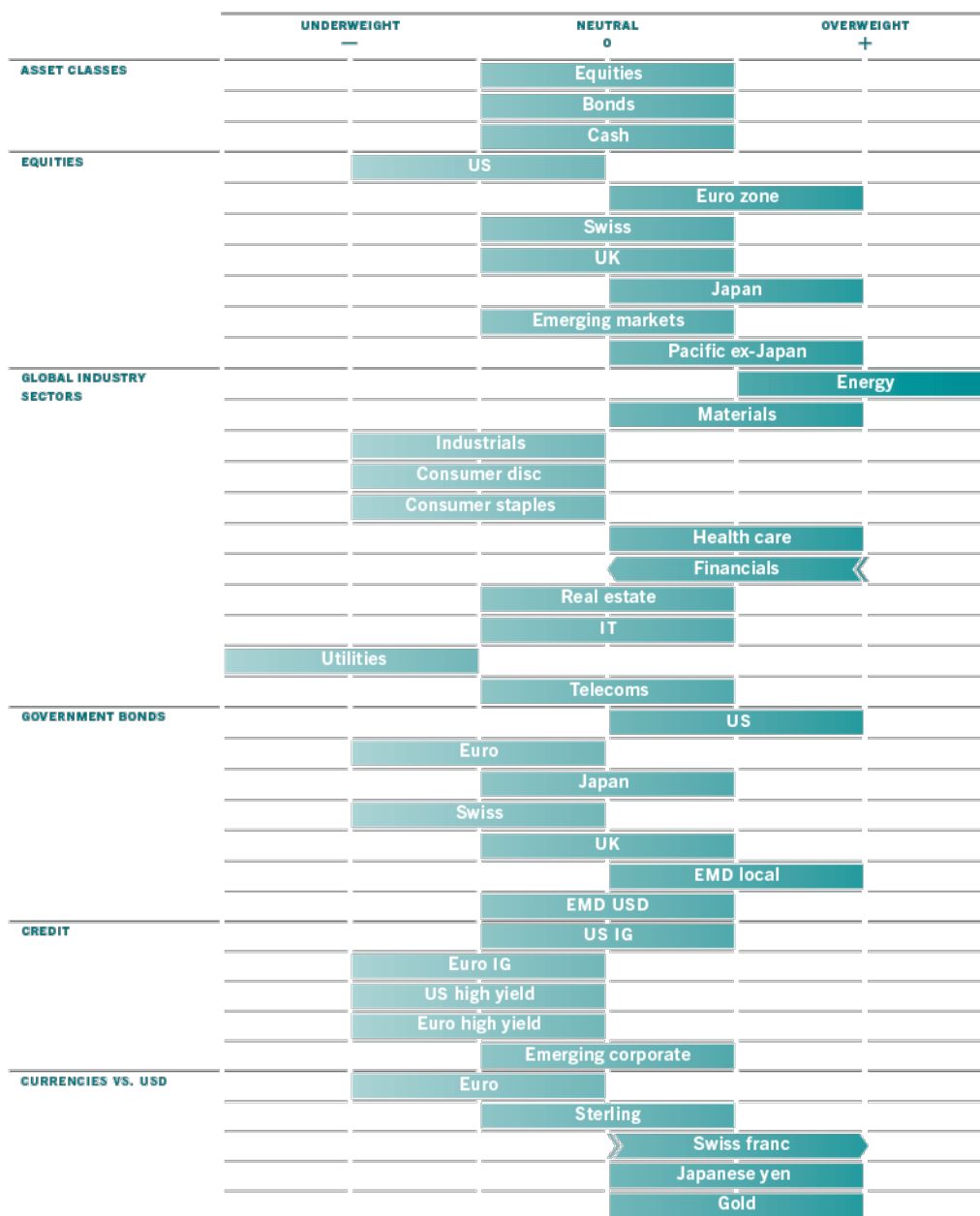
- 01** Asset allocation: in a holding pattern
- 02** Equity regions and sectors: trimming cyclicals
- 03** Fixed income and currencies: reaching out for income, hedging risk
- 04** Global markets overview: tech supports stocks, EM wobbles

# Asset allocation: in a holding pattern

It's been a tough month for investors. From the Italian political crisis to simmering US-China trade tensions, not to mention a sharp sell-off in some emerging market currencies, there has been plenty to worry about. But there's no need for panic. For one thing, the global economy is humming along, even though the pace of growth has slowed in the past few months. And while the US Federal Reserve seems intent on sticking to its well-publicised programme of gradually raising interest rates, we don't think it is in a hurry to tighten monetary policy. Nor, for that matter, are any of its peers in the developed world. If anything, we believe monetary authorities are prepared to slow the pace of stimulus withdrawal should threats to growth materialise, particularly the European Central Bank.

Against this backdrop, we're keeping our neutral position on equities, bonds and cash. We are dialling back our cyclical bias slightly by lightening up on financials and raising our exposure to the Swiss franc to overweight as a hedge against market turbulence.

MONTHLY ASSET ALLOCATION GRID  
June 2018

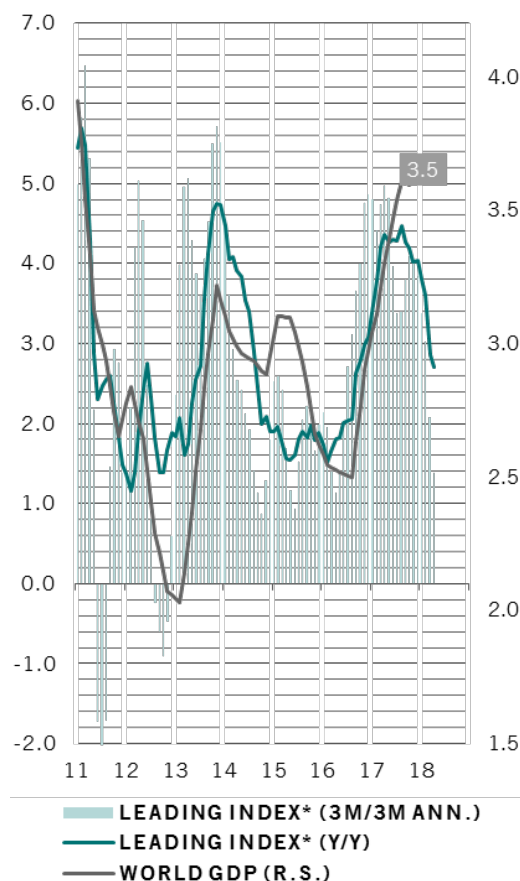


Source: Pictet Asset Management

Our **business cycle** gauges continue to show a divergence in economic conditions between developed and emerging countries. Leading indicators in industrialised nations fell for the fourth consecutive month, while the readings for their developing counterparts have held steady. In the US, the construction sector is starting to feel the chill from monetary tightening; other data show private consumption is healthy.

The outlook is a little less encouraging for the euro zone, where leading indicators dropped below the three-year average even before the latest bout of political turmoil in Italy. That said, we think the euro zone economy will be supported by improving labour market conditions and an uptick in business investment. We don't expect the Italian political crisis to pose a systemic threat to the region's banking system. What is more, European leaders may yet come up with policies to soothe investor jitters at their June summit.

TURNING POINT?  
World leading indices and GDP growth, %



\*Weighted average of 39 countries' leading indicators.  
\*\*Mixed forecasting of four approaches to estimate potential growth. Source: Thomson Reuters Datastream, CEIC, Pictet Asset Management. Data covering period 01.01.2011 to 30.04.2018

Our **liquidity readings** remain negative for riskier assets. Worries about Italy have helped send the dollar higher, which is in turn putting pressure on currencies of emerging countries that are most reliant on dollar funding, such as Argentina and Turkey. We expect the effect of tighter liquidity to be felt more in coming months: central banks are removing liquidity at an annualised rate of about USD700 billion and our analysis shows it takes up to 18 months for any tightening to feed through to the broader economy.

The **valuation** signals we monitor suggest taking a neutral stance on equities. But there's a wide dispersion in valuations between regions and sectors. Japan remains the cheapest developed equity market. The US is the least attractive, especially if we are right in assuming that market expectations for corporate earnings growth will ease to a more realistic level of about 18 per cent this year from the current 22 per cent. Commodity-related sectors, such as energy and materials, look more appealing as they tend to outperform in the late stage of the economic cycle. Other cyclical sectors – industrials and consumer discretionary stocks in particular – look expensive. Elsewhere, emerging local currency debt and currencies look attractive after a recent sell-off; European credit is vulnerable to any re-rating of euro zone sovereign debt triggered by Italy's political ructions.

**Technical** indicators have turned positive for some riskier assets after a recent correction in stock markets. However, equities are likely to struggle due to seasonal factors - summer months don't tend to be kind to stocks. That said, the technical picture for European stocks looks encouraging. The asset class has seen unusually large investor outflows since March, with European equity funds losing nearly half the capital allocated since December 2016.



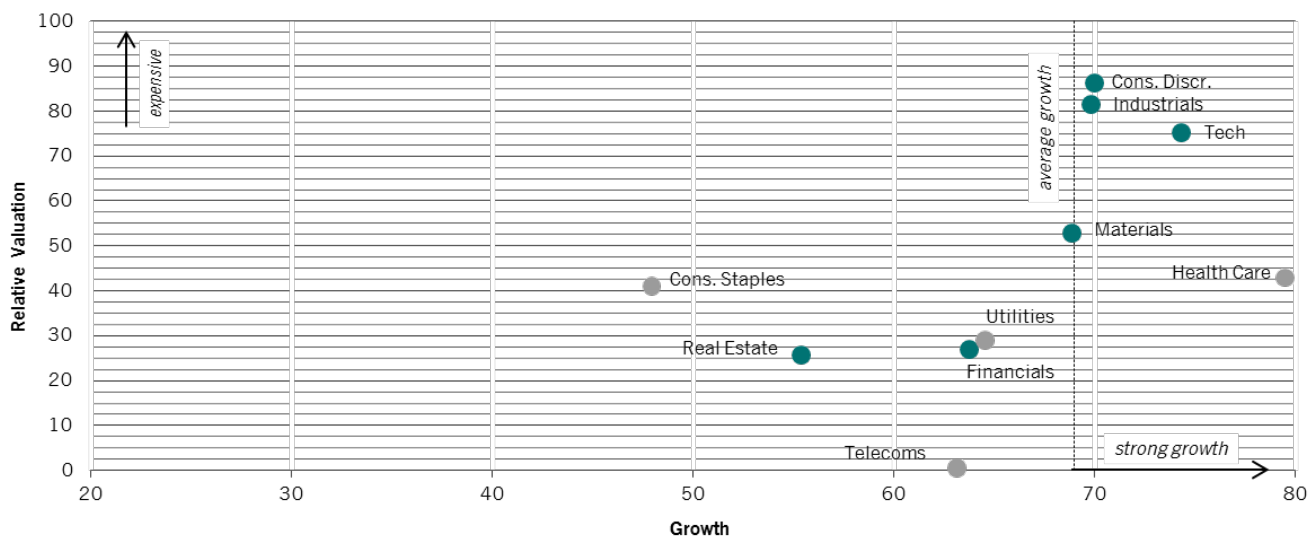
# Equity regions and sectors: trimming cyclicals

Signs that global growth is levelling off have prompted us to scale back our overweight stance on cyclical stocks, particularly on financials. Banks' lending margins could come under pressure if a slight cooling of economic conditions prevents the bond yield curve from steepening. At the same time, Italy's political upheavals represents a risk for European banks. For instance, 14 of Europe's banks have holdings of Italian sovereign debt that is bigger than their capital buffers, according to IESEG School of Management.

At the same time, global cyclical stocks are trading at a near-record 27 per cent premium relative to defensives, against a long-term average of 10 per cent.

## EXPENSIVE CYCLICALS

Relative sector valuation compared to growth prospects



📷 Growth score is an average of lead index level, lead index change, CESI, GDP revision, MCI (all adjusted by geographic revenue exposure to regions); as well as sector specific macro drivers EPS change; and net EPS upgrades (20-year percentile). Relative valuation score is an average of price to book, 12m PE, PE on trend EPS, price to sales, equity risk premium (for DM countries only) relative to MSCI ACWI (20-year percentile). Average growth is market cap weighted. Source: Pictet Asset Management. Data as of 25.04.2018.

We are even less enthusiastic about the prospects for US equities, where a considerable amount of good news is already priced in. During the latest reporting season, earnings per share grew by nearly a quarter on the year while sales jumped more than 8 per cent, with almost 80 per cent of companies beating analyst forecasts. But this is likely to be the high water mark in the current cycle. Analysts are looking for some 20 per cent earnings growth for the calendar year as a whole – which our fundamental models suggest is too optimistic. So while US equity valuations have dropped sharply as share prices dipped while earnings jumped, they're not compelling enough to compensate for the risks of rising interest rates.

On the other hand, we remain overweight euro zone equities, which should benefit from the fact that the region is lagging the US economic cycle. Plenty of bad news is already in the price of the region's stocks - European earnings are expected to grow 7 per cent this year and 9 per cent next, and the euro's relative weakness should offer additional support.

That's subject, of course, to how the Italian political crisis develops. There's a possibility the populists' coalition could yet be prove strongly anti-EU, leading to further bond and equity market losses. But we think the new government is likely to be less market unfriendly than initially feared.

Meanwhile, Japanese growth has stalled during the past couple of quarters, dented by trade-dependent sectors. But we retain an overweight on Japanese shares: not only are their valuations compelling but they should continue to draw support from an accommodative central bank.

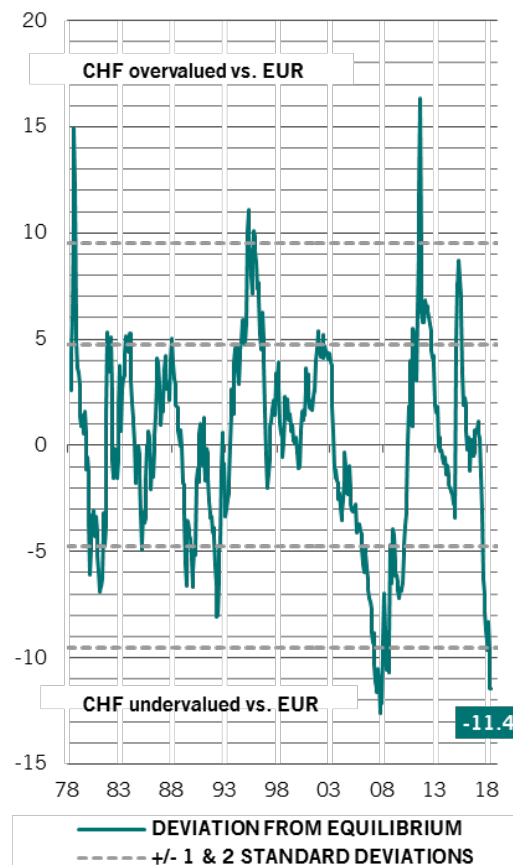
Elsewhere, emerging market equities are handing back some of their gains following a stellar 2017, where they surged 38 per cent. Year to date emerging market equities are down around 1 per cent in dollar terms. Countries with large external funding needs are under most pressure, such as Argentina, Turkey and South Africa. By contrast Russia, Taiwan and India are least vulnerable.

What seems likely across the board is that higher volatility will become the norm, with lower returns, creating a challenging environment for investors in this asset class.

# Fixed income and currencies: reaching out for income, hedging risk

Whenever Italian politics becomes the dominant force in fixed income markets, tactical trades become especially tricky to pull off. It's doubtful, for instance, that many bond investors will have foreseen Italy's two-year borrowing costs surging from minus 17 basis points in April to as high as 272 basis points before moving back down again to about 100 basis points by the end of May.

SWISS BARGAIN  
Deviation of Swiss franc value from equilibrium level  
against euro, standard deviations



Source: Thomson Reuters Datastream, CEIC, Pictet Asset Management. Data covering period 01.01.1978 to 01.05.2018.

For all this volatility, our decision to maintain an underweight position in European fixed income – both in sovereign and corporate debt – is not just down to the turmoil provoked by simmering political tensions in the euro zone. It has more to do with the fact that the most attractively-valued fixed income investments lie outside the single currency region.



Our leading indicators show developing economies doing better than their developed counterparts, and emerging market local currency bonds look relatively good value. With both yielding around 6 per cent – more than US high yield debt – and with emerging market currencies looking cheap relative to the dollar, the asset class remains an attractive source of income.

At the same time, we are mindful of the need to insure against the possibility of further market volatility.

US Treasury bonds continue to be an attractive hedge against market upheavals given their relatively high yields and status as a haven; we also remain short the euro given the political uncertainty in Italy and Spain, where centre-right prime minister Mariano Rajoy was recently forced out of office after losing a confidence vote.

In addition, we have raised our exposure to the Swiss franc – a currency that should gain in the event of geopolitical turmoil. On a trade-weighted basis, the franc is trading more than two standard deviations below its fair value (see chart). It has not been this cheap since the great financial crisis, according to our calculations.

# Global markets overview: tech supports stocks, EM wobbles

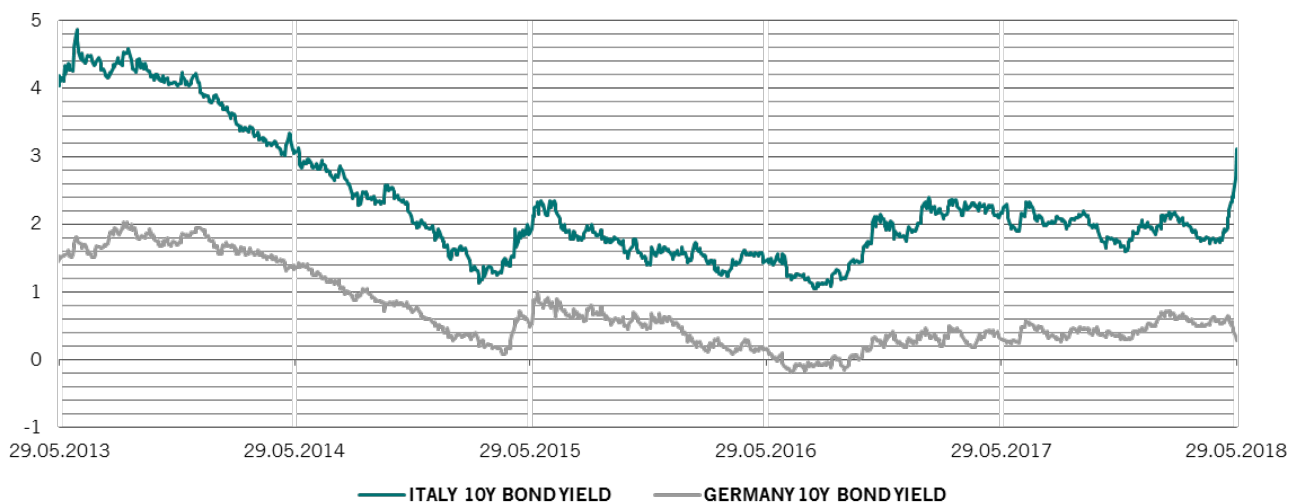
Global stocks rose nearly 1 per cent in May in local currency terms as strong corporate earnings results helped ease investor worries about the political turmoil raging in Italy, Argentina and Turkey. Tech stocks were the biggest gainers, rising nearly 6 per cent on the month. The NYSE Fang+ index of tech leaders such as Amazon and Netflix is now up some 26 per cent since the start of 2018, and was within sight of a new record high.

The energy sector drew support from rising oil prices, which climbed more than 4 per cent on strong global demand and supply shortfalls in Venezuela and Iran.

European stocks, underperformed Asia and the US as Italy's political crisis raised concerns about the impact of the country's deteriorating finances on the region's financial sector. Emerging market stocks fell across the board, with Latin American bourses losing as much as 9 per cent as Argentina's plunging currency forced the region's third biggest economy to ask the IMF for support. The peso has lost around a quarter of its value against the dollar since January.

## SPREADING WORRIES

Italian and German 10-year bond yields, %



Source: Thomson Reuters Datastream. Data covering period 29.05.2013 to 29.05.2018

In fixed income, the focus remained squarely on the Italian bond market, which saw unprecedented levels of volatility. The two-year note traded within a 300 basis point range in just two days. The premium in yield investors demand to hold Italian debt, meanwhile, hit its highest level since October 2013.

More broadly, global bonds eked out slim gains as weaker-than-expected US data and jitters over a transatlantic trade dispute cemented expectations that the pace of Fed interest rate hikes would be gradual. The Treasury yield curve – the spread between the five-year and 30-year bond yields – hit its narrowest since July 2007 at one point as geopolitical tensions encouraged investors to seek safety in longer-dated government paper. US government bonds also drew support from the dollar, which hit a five-month high against the euro and ended the month up 1.6 per cent against a basket of currencies.

The dollar's strength weighed on asset prices in a number of emerging markets which rely on external financing. Emerging local currency debt was particularly hard hit, losing some 5 per cent on the month, giving up a third of the gains it made in 2017.

The Turkish lira hit a record low against the dollar, falling more than 10 per cent during the month as investors grew nervous that President Tayyip Erdogan would take more control of interest rates if he wins elections in June as expected.

#### Important legal information

This marketing document is issued by Pictet Asset Management. It is neither directed to, nor intended for distribution or use by any person or entity who is a citizen or resident of, or domiciled or located in, any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation. Only the latest version of the fund's prospectus, the KIID (Key Investor Information Document), regulations, annual and semi-annual reports may be relied upon as the basis for investment decisions. These documents are available on [assetmanagement.pictet](http://assetmanagement.pictet).

This document is used for informational purposes only and does not constitute, on Pictet Asset Management part, an offer to buy or sell solicitation or investment advice. It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. The effective evolution of the economic variables and values of the financial markets could be significantly different from the indications communicated in this document.

Information, opinions and estimates contained in this document reflect a judgment at the original date of publication and are subject to change without notice. Pictet Asset Management has not taken any steps to ensure that the securities referred to in this document are suitable for any particular investor and this document is not to be relied upon in substitution for the exercise of independent judgment. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Before making any investment decision, investors are recommended to ascertain if this investment is suitable for them in light of their financial knowledge and experience, investment goals and financial situation, or to obtain specific advice from an industry professional.

The value and income of any of the securities or financial instruments mentioned in this document may fall as well as rise and, as a consequence, investors may receive back less than originally invested. Risk factors are listed in the fund's prospectus and are not intended to be reproduced in full in this document.

Past performance is not a guarantee or a reliable indicator of future performance. Performance data does not include the commissions and fees charged at the time of subscribing for or redeeming shares. This marketing material is not intended to be a substitute for the fund's full documentation or for any information which investors should obtain from their financial intermediaries acting in relation to their investment in the fund or funds mentioned in this document.

EU countries: the relevant entity is Pictet Asset Management (Europe) S.A., 15, avenue J. F. Kennedy, L-1855 Luxembourg

Switzerland: the relevant entity is Pictet Asset Management SA, 60 Route des Acacias – 1211 Geneva 73

Hong Kong: this material has not been reviewed by the Securities and Futures Commission or any other regulatory authority. The issuer of this material is Pictet Asset Management (Hong Kong) Limited.

Singapore: this material is issued by Pictet Asset Management (Singapore) Pte Ltd. This material is intended only for institutional and accredited investors and it has not been reviewed by the Monetary Authority of Singapore.

