

BAROMETER

GLOBAL ASSET CLASSES
We stick to our overweight



ASSET ALLOCATION

LONG-TERM MARKET OUTLOOK

Dry summer for stocks

Barometer

July 2018

Pictet Asset Management Strategy Unit

Bonds are likely to take the upper hand over equities this summer, as liquidity dries up and economic growth slows.

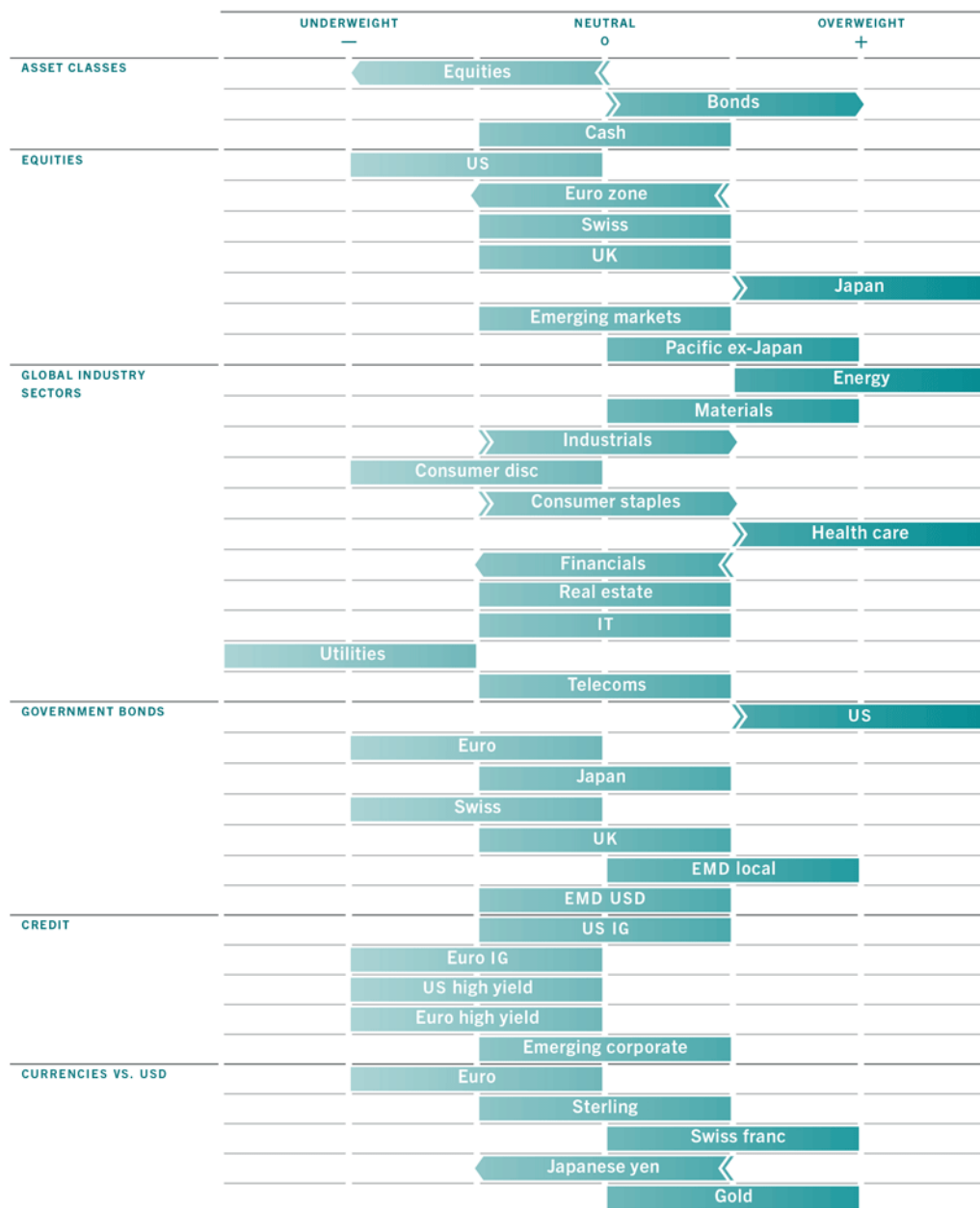
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Asset allocation: no easy living for equities

The summer months might be a time for relaxation, but not for investors. To the investment community, it's a season characterised by volatile markets and lacklustre equity returns. This year, that trend could be even stronger than normal thanks to a loss of momentum in the global economy, a draining of monetary stimulus and overly optimistic corporate earnings expectations.

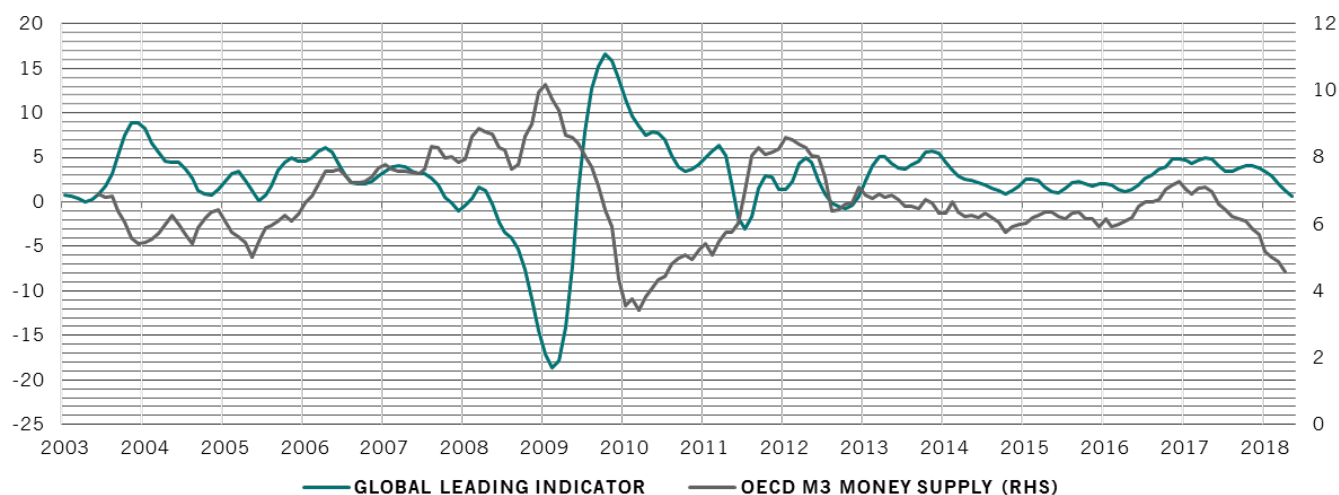
Some caution seems warranted, at least in the near term. We therefore downgrade equities to negative, and raise our allocation to fixed income to overweight.



Source: Pictet Asset Management

Our **business cycle** indicators suggest that global economic growth is going to continue its gradual deceleration in the coming months, particularly in developed countries (see chart).

Of all the geographic regions, only Latin America still has an above-trend leading indicator reading. Most of the negativity elsewhere is a reflection of deteriorating consumer and business sentiment, so it could prove relatively short lived, particularly as interest rates around the world still remain supportive of economic activity. But for now, certainly, the macroeconomic backdrop is relatively less favourable for equities and other risky assets, such as high yield debt, on which we are also underweight.



Source: Datastream, OECD, Pictet Asset Management. Data covering period 01.02.2003 - 15.04.2018

Influenced by a tightening of the monetary reins in the US, our world **liquidity** gauge remains in negative territory. Indeed, the US Federal Reserve has already administered the equivalent of 440 basis points of interest rate hikes, if you include the removal of its quantitative easing policy. That equates to the average cumulative tightening of the past 16 cycles, stretching back to 1919. We believe this draining of monetary stimulus is already affecting financial markets, and that impact is likely to be magnified through the widening of risk premia.

Valuations don't paint a positive picture either. Within equities, there are several areas that look too expensive. Cyclical stocks are among those, trading at a near-record 26 per cent premium relative to their defensive counterparts on cyclically-adjusted price-earnings basis, compared to a long-term average of 10 per cent. What is more, our negative excess liquidity readings¹ are consistent with a further 5-10 per cent decline in price to earnings ratios by the end of the year.

Technical gauges that capture seasonal factors support our asset allocation stance, with strongly positive readings for bonds and strongly negative ones for equities.

Given the potential for a pick-up in volatility over the summer months, it is also worth noting the build-up of short positions on the VIX. If this risk appetite gauge were to fall – which seems quite likely at some point during skittish summer trading – that could send significant waves through financial markets.

[1] The difference between money growth and nominal GDP growth

Equity regions and sectors: looking to the defence

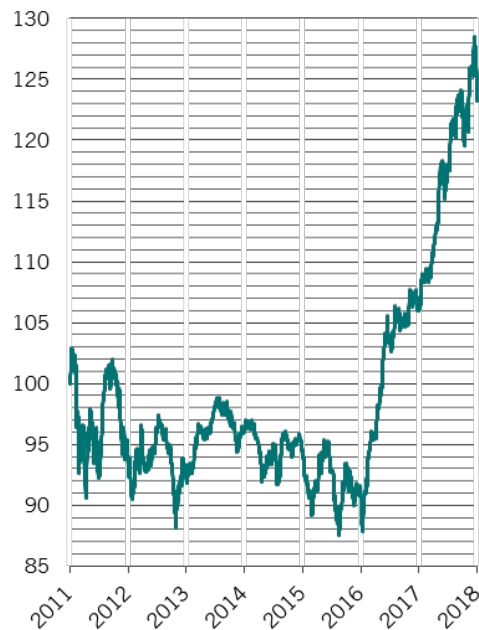
As the footballers at this year's World Cup know, sometimes you have to sit back a bit and rely more on your defence. That's currently our stance on equities.

With the global economy losing steam – leading indicators for developed markets in particular are looking softer – we've trimmed our exposure to economically-sensitive stocks and added to sectors that are best placed to weather a downturn. We raised our stance on consumer staples and lifted healthcare to a full overweight. At the same time, we've reduced financials to neutral.

Healthcare looks particularly interesting, having been a relative laggard during the past twelve months.

On the other hand, financials have struggled lately, as investors start to worry about rising default rates and paltry spreads. It's potentially a worrying sign that companies have cut back on issuing high yield debt and instead have been raising finance through much less liquid avenues like loans and private placements. That might spell trouble for banks, and we have consequently cut our exposure to the sector to neutral from overweight.

CYCLICALLY EXPENSIVE
Cyclicals vs defensives, relative performance, 24.06.2011
= 100



Equal-weighted relative performances. Cyclicals = Industrials, Cons Disc, IT, Materials. Defensives = Cons Staples, Healthcare, Telecoms, Utilities. Source: Datastream. Data from 24.06.2011 to 27.06.2018.

We have become neutral on industrial stocks on valuation grounds, after the sector has underperformed the MSCI World index by some 6 per cent since the end of January.

Among equity regions, we reduced our euro zone position to neutral from overweight. The single currency bloc's economy has been struggling lately. Italy's immediate political upheavals may be over for now, but the prospect of a flare-up will hang over the region for a while yet. And then there's the matter of US tariffs. With European economies like Germany heavily geared towards trade, anything that threatens to undermine its exporters is likely to be a concern.

On the other hand, we've increased our stance on Japanese equities to a full overweight. We think the stocks are underappreciated – they're relatively cheap on valuation grounds while earnings prospects are looking positive even as analyst expectations are being reduced for other major developed markets.

We remain underweight of US equities. The market remains expensive. Tech stocks have been the dominant driver, but they are on high valuations. We expect US earnings growth to fall short of the 10 per cent analysts expect for 2019 – not only is it likely that the pace of economic growth will have peaked during the second quarter of this year, but a strong dollar is bound to put corporate margins under pressure. What's more, the Federal Reserve is likely to ignore market volatility as long as unemployment remains near multi-decade lows and President Trump's tax cuts and fiscal programme continue to flow through to the real economy.

Fixed income and currencies: seeking safety

With the much of the world economy slowing down, we have decided to raise our allocation to fixed income, primarily US government bonds.

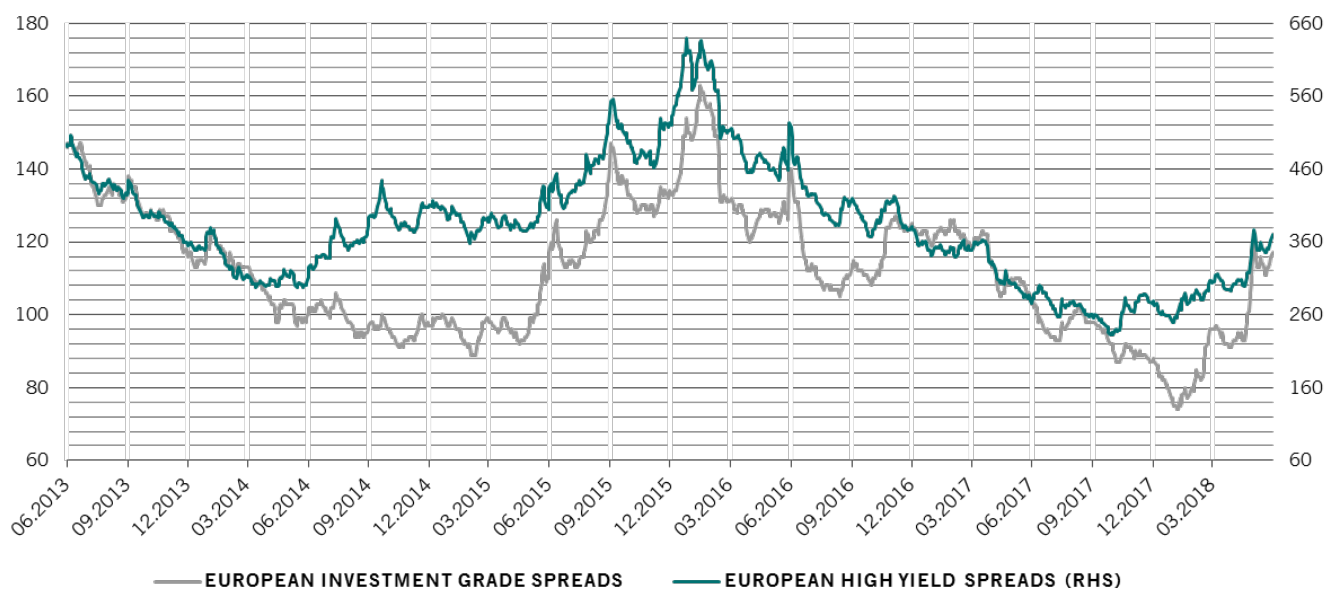
US Treasuries are among the most attractive defensive fixed income assets for a number of reasons. The first is fundamental. Yields on US bonds look too high at a time when escalating **trade tensions** between the US and China threaten to dampen both US and world economic prospects and cause the Fed to slow the pace of interest rate hikes.

The second is seasonality. Equity markets tend to be more volatile during July and August, which in turn could lend a strong bid to US government bonds. The third is relative valuation. The gap between US sovereign bond yields and others is too wide, with the difference between 10-year Treasuries and the German counterpart hitting a near-record 2.5 per cent.

Euro zone fixed income assets look less appealing. Not only is the European Central Bank phasing out its three-year EUR2.4 trillion stimulus programme by the end of the year but it is doing so at a time when political uncertainty in Italy could derail reform of the euro zone in areas such as banking, public spending and immigration.

CREDIT SQUEEZE

Option Adjusted Spreads of ICE BofAML Euro Corporate Index and ICE BofAML Euro High Yield Index over German bunds, in basis points



Source: Thomson Reuters Datastream, data covering period 26.06.2013 – 26.06.2018

Investors have already started to bail out of euro zone fixed income assets. EPFR Global data showed European bond funds saw outflows of USD2.4 billion in the week to June 13, the biggest in over a year.

We are also underweight US high yield, whose spreads have room to widen from here to keep pace with their investment grade counterpart. That is in line with our overall cautious view on credit as the asset class tends to peak before equities do in the late stage of the business cycle.

Emerging market local currency bonds look more attractive following their near-6 per cent fall since the beginning of the year. Our models also show that emerging currencies – a key component of such bonds' total return – are some 20 per cent undervalued versus the US dollar.

Elsewhere, we've shifted to a neutral stance on the yen, mindful that the dollar is likely to strengthen in the near term. We maintain our underweight stance on the euro.

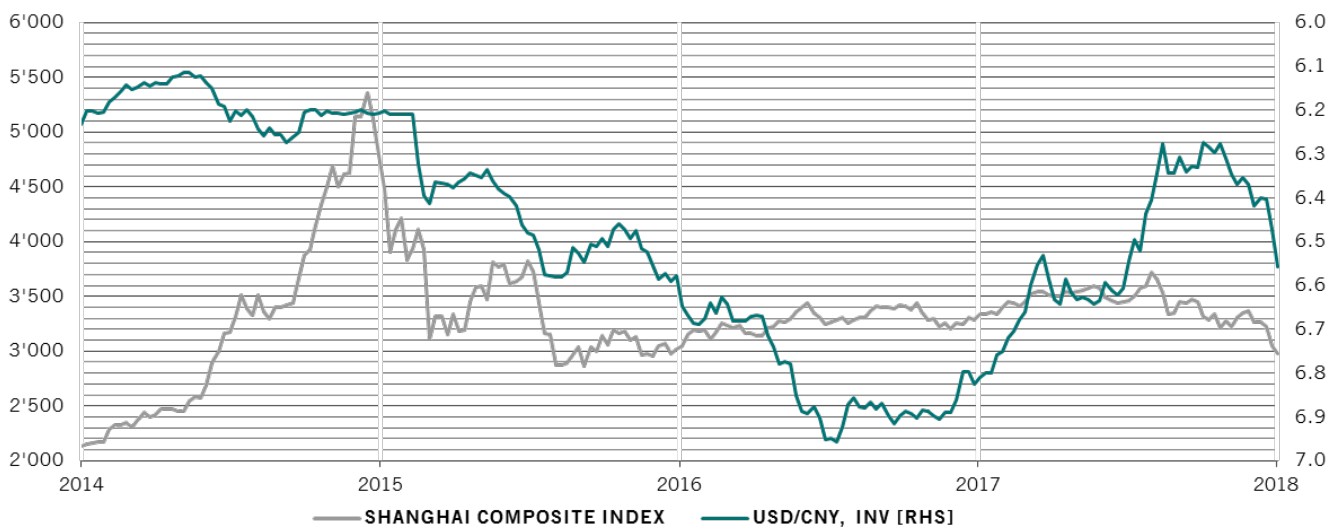
Global markets: hit by trade tensions

Global equities held steady in June in local currency terms as investors swapped cyclical financial and technology stocks – down, respectively, 1.6 and 0.8 per cent on the month – for more defensive holdings like consumer staples, healthcare and utilities. Energy shares were a notable exception to this rotation out of economically-sensitive stocks, gaining 1.2 per cent thanks to a rally in oil prices.

On a regional basis, Asian emerging market stocks delivered the weakest performance, shedding 3.3 per cent on the month and moving into the red for the year as investors fretted about the fallout from escalating trade tensions between the US and China. Washington has threatened to impose tariffs on up to USD450 billion of Chinese imports, with the first portion set to kick in on July 6.

Consequently, for the Shanghai bourse, June proved to be the worst month in two years, while for the yuan it was the worst on record versus the US dollar (see chart).

CHINESE RETREAT



Source: Datastream. Data covering period 25.06.2013 - 26.06.2018

US Treasuries, traditionally seen as one of the safest asset classes, benefitted from the rise of risk aversion. But overall they only managed a flat showing overall due to Fed tightening.

In the euro zone, where the central bank is in no hurry to raise rates, German government bonds gained as concerns over the single currency region's political instability grew. A new populist government took power in Italy, while in Germany Angela Merkel's ruling coalition is looking increasingly unstable, with both developments raising uncertainty over the direction of fiscal policy as well as over the likelihood of closer euro zone integration.

Emerging market debt tracked other EM assets lower. Central banks in a number of developing countries – including Argentina, Turkey, India, Indonesia and the Philippines – responded to the weakness of their currencies by tightening monetary policy.

In foreign exchange, the dollar drew strength from the Fed hiking rates again and maintaining a hawkish tone. That helped the greenback gain ground versus most major peers – both emerging and developed – and translated into a 1.5 per cent rise versus a trade-weighted basket of currencies.

Dollar's gains were gold's losses, with bullion prices dropping 4.1 per cent in June. Unusually, gold has not benefited from safe haven flows during the escalating trade tensions.

BAROMETER JULY 2018

Asset allocation

We downgrade equities to underweight and raise bonds to overweight.

Equity regions and sectors

Increasing allocation to defensive sectors, and turning more cautious on cyclical financials.

Fixed income and currencies

We increase our weight on US Treasuries, but remain cautious on euro zone bonds.

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