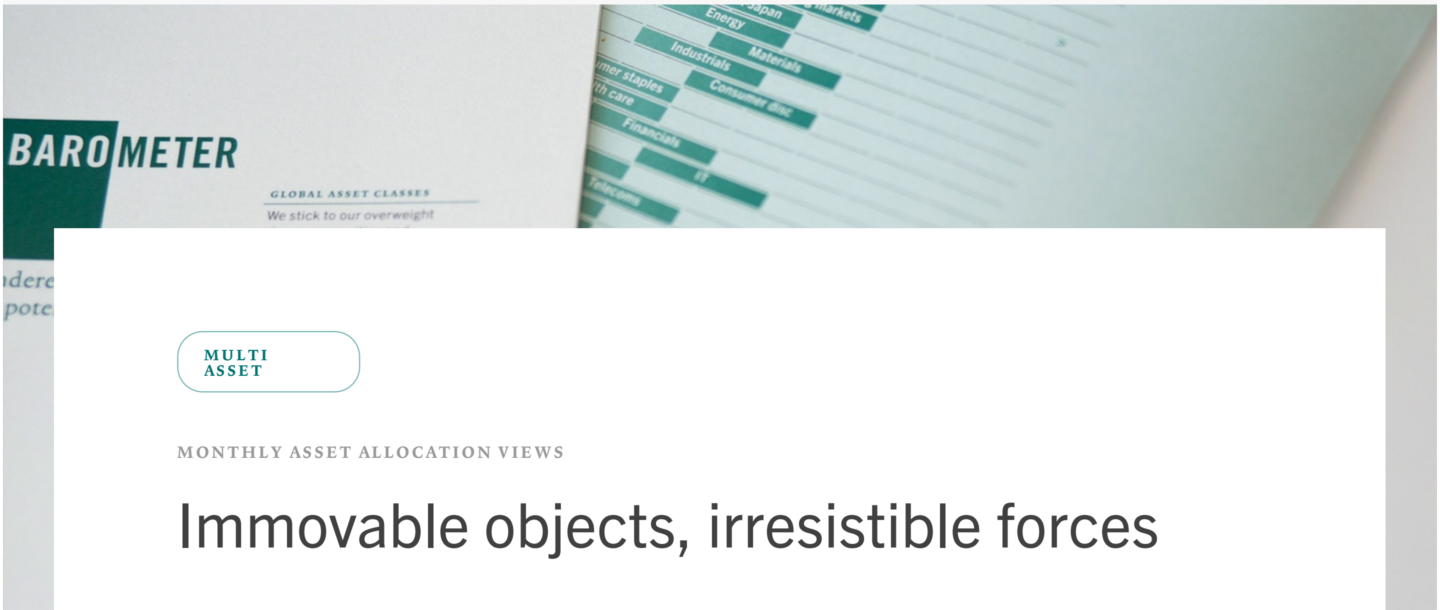
PICTET
Asset Management



MULTI ASSET

MONTHLY ASSET ALLOCATION VIEWS

Immovable objects, irresistible forces

Barometer, October 2018

October 2018

Pictet Asset Management Strategy Unit

Equity markets are likely to be held in check by simmering trade tensions and tighter monetary conditions, even if corporate profits remain healthy.

Table of contents

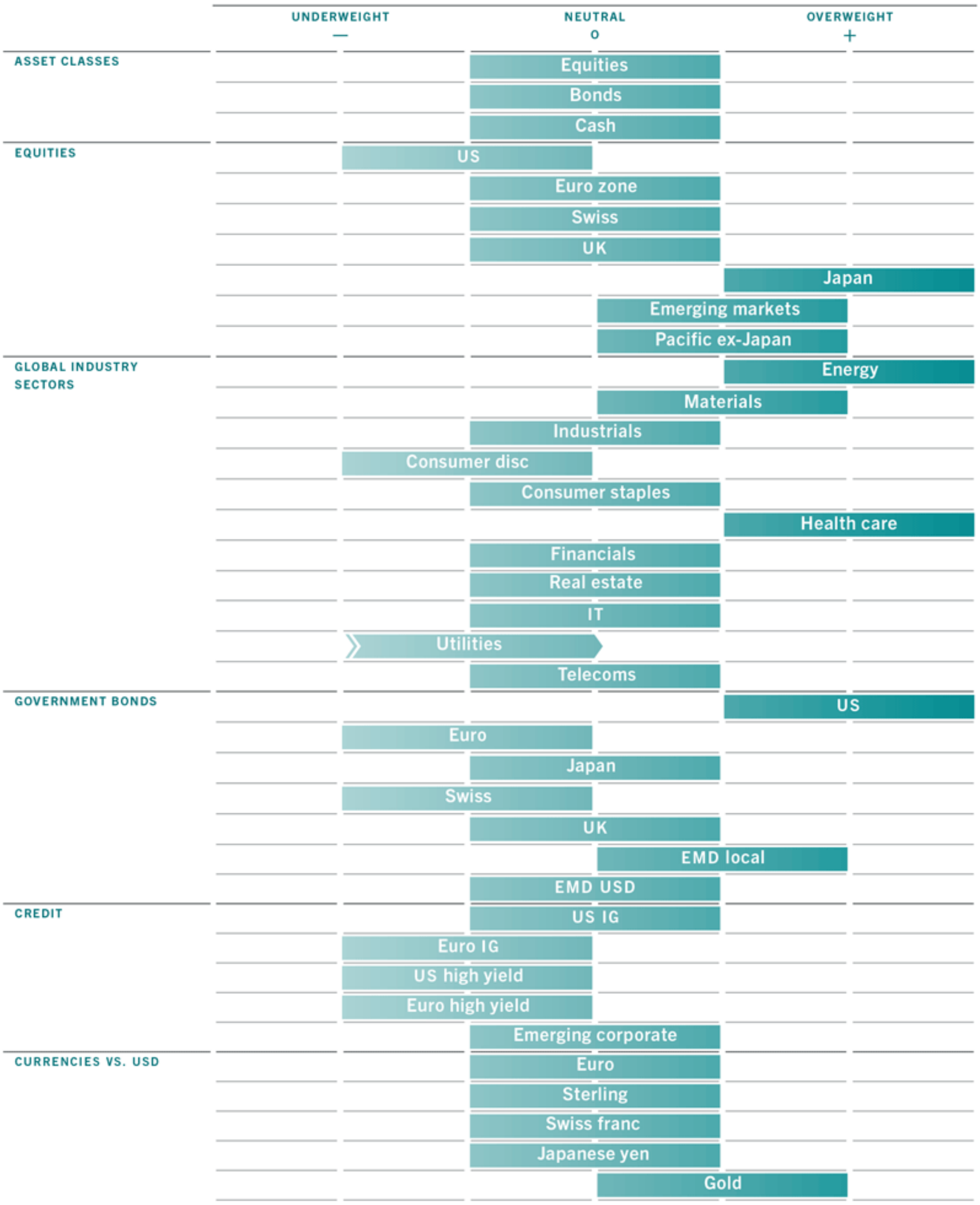
01

Asset allocation: balanced forces

Strong corporate earnings, steady economic growth and the lack of fallout – so far – from trade wars are helping to mitigate the US Federal Reserve's steady withdrawal of liquidity from the global system.

The tension between these opposing forces is likely to continue for the coming months. The pace at which the Fed's balance sheet is due to shrink hits a peak in early October, while the European Central Bank's asset purchase programme is coming to an end this year.

And although corporate earnings continue to grow, there are signs momentum could be slowing – perhaps unsurprising given the pace at which profits were previously expanding.



Source: Pictet Asset Management

Countering this is the US's fiscal stimulus programme, which hits full throttle in the first quarter of 2019 and the tempering of the Chinese government's push to deleverage the economy after signs growth was starting to flag.

Taking these offsetting factors into account, we are maintaining our neutral weightings on the three main asset classes, equities, bonds and cash.

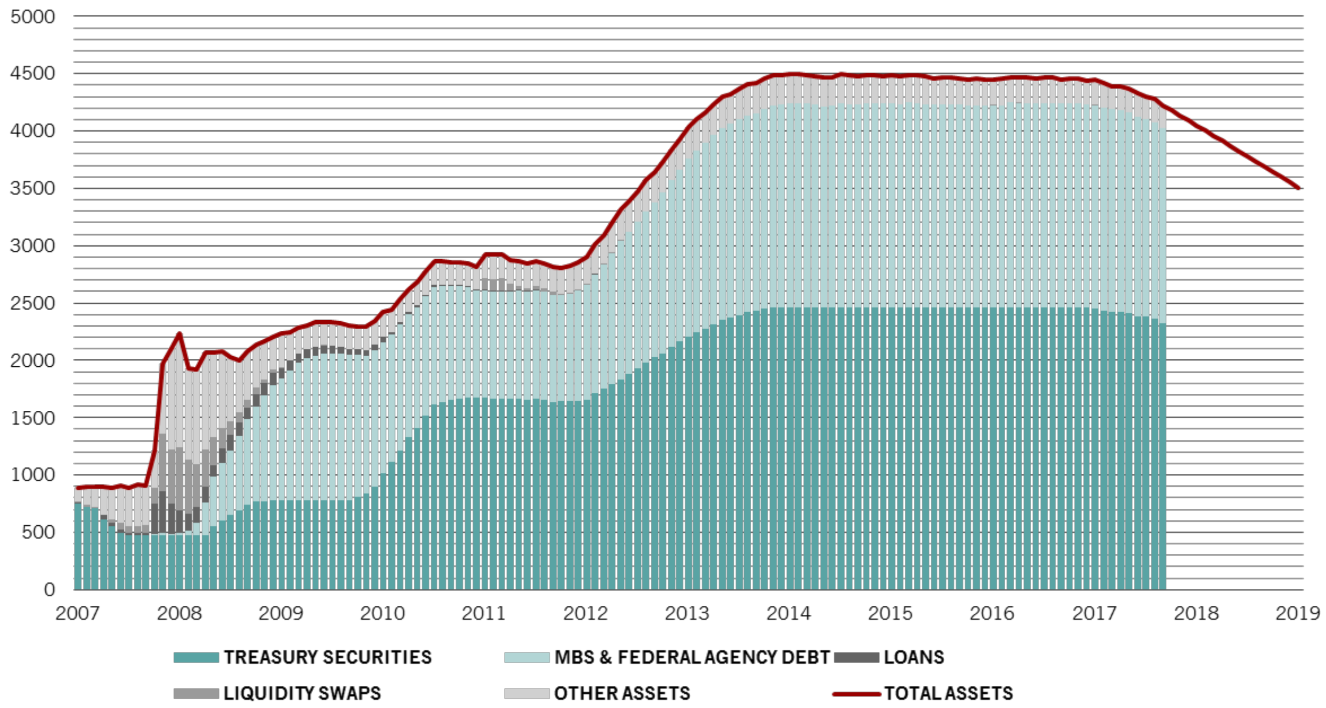
Our global **business cycle** indicators are tilting positive. Our generally upbeat reading of the US economy is balanced against concerns about trade tensions and the impact tightening monetary policy is beginning to have on interest-rate sensitive industries, particularly construction and residential investment.

China's leading indicators, meanwhile, have rebounded from weakness earlier this year. A drop in car sales is likely to be the temporary effect of ending sales incentives. And weak infrastructure spending is offset by growth in private housing. Besides, the government is likely to boost infrastructure investment should the economy falter.

Our global **liquidity** readings remain neutral. Monetary tightening and a slowdown in private credit creation in the US is being offset by massive liquidity flows into the country from the rest of the world. That's not just a matter of repatriation of US corporate cash from abroad. Investors worldwide are focused on strong US corporate earnings, a strong dollar and the prospect of rising US bond yields. These flows help explain why the US equity market has been so robust this year while those in the rest of the world have struggled.

SHRINKAGE

US Federal Reserve balance sheet, actual and forecast, USD billion



Source: US Federal Reserve, data covering period 31.12.2006-21.09.2018. Projections based on Federal Reserve estimates.

Our **valuation** metrics show that global equities are in neutral territory, albeit with large valuation gaps within the asset class. Global bonds are looking slightly less expensive - but still overvalued. Emerging market (EM) local debt isn't as quite as cheap as it was last month, though with EM currencies still 20 per cent undervalued against the dollar, they're still attractive. Corporate bonds, especially in Europe, are expensive and carry lower credit ratings, on average, than in the past.

From a **technical** standpoint, seasonal factors strongly favour equities across all regions apart from emerging markets, while Japanese stocks look overbought. The technical picture for EM assets is mixed: on the one hand, investment flows seem to be stabilising, but, on the other, the degree to which these flows are dispersed across developing countries' markets remains poor. One point worth noting is that using the VIX to hedge against volatility in other asset classes hasn't worked lately as the correlation among the returns of different asset classes has been unusually high.

02

Equity sectors and regions: going for gold in Japan

When it comes to autumn, Japan and the United States both top the lists of the best places to admire red and gold foliage. When it comes to equities, however, the Japanese and American landscapes could not be more different.

For a start, Japan is the cheapest of the developed markets, according to our valuation models, while the US is comfortably the most expensive. Secondly, the Bank of Japan is still pumping money into the market (albeit it a slower pace than before), while the Fed is doing the reverse, having delivered its third interest rate hike of the year last week. Our analysis. based on lead indicators, bond yields and the yen, suggests Japanese stocks are 26 per cent cheaper than they should be compared to their global peers.

Equity investors are starting to notice this anomaly, with Japanese stocks rebounding in September while their US counterparts made little progress. Notably our technical model shows that investor positioning on Japan is still neutral. We believe there is still a large price gap to close and so stick to an underweight position in US stocks and an overweight stance on Japanese equities.

We remain attracted to EM stocks. Despite recent gains there, valuations remain very compelling, while investor positioning is still very light. Leading indicators of activity and corporate earnings remain resilient in the vast majority of emerging economies and we do not expect the dollar to rise much further from here.

Europe could well be the next regional equity market to gain momentum, but – in the absence of a clear trigger – we favour a neutral allocation for the time being.

HEALTHY RETURNS
MSCI ACWI health care price index

Source: Thomson Reuters Datastream. Data covering period 22.09.2015 – 25.09.2018

When it comes to equity sectors, technology continues to dominate both the year-to-date performance tables and the headlines. Valuations for such stocks are extremely stretched, however, and have become more so in the past three months.

Technical indicators, meanwhile, are positive. For now, we think the risks are fairly evenly balanced, although that could change once the dust settles on S&P's and MSCI's introduction of a new communications sector to absorb the likes of Facebook and Google's parent Alphabet.

We believe the investment case for second best performing sector of 2018 — healthcare — is much more clear-cut (see chart). It is well-placed to benefit from continued investor preference for defensive sectors, while still offering exposure to long-term secular megatrends through latest medical innovations.

Growing investor appetite for defensive stocks has also prompted us to reconsider our stance on utilities, which we upgrade to a single negative from a double one.

However, the considerable increase in the sector's **leverage levels** in recent years remains a sizeable risk. Globally, utilities' net debt to trend EBITDA is second only to real estate, and at the top of the 20-year range.

03

Fixed income and currencies: keeping faith in emerging markets

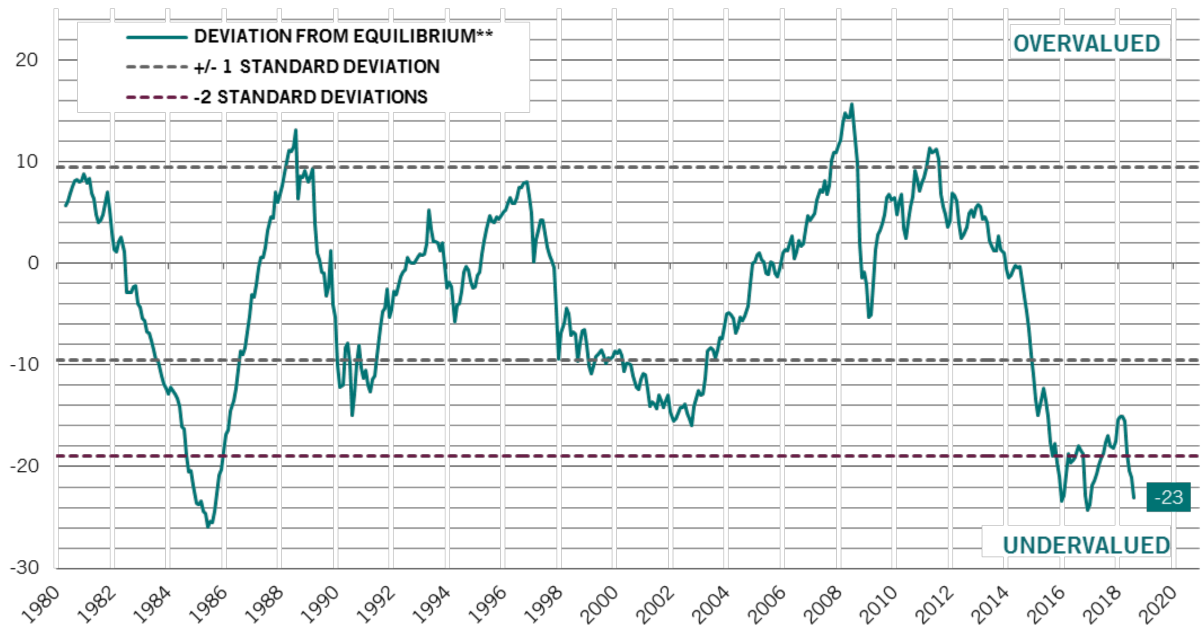
With both Argentina and Turkey flirting with crisis, fears are growing that these local difficulties could morph into something more systemic.

By far the easiest way for such problems to infect other markets is via a shift in sentiment. There is always the temptation among investors to lump emerging nations together and dump their currencies and assets wholesale when problems strike.

That could happen still – after all, Turkey was not the only country whose government and corporations took advantage when US rates were low to boost borrowing.

But dig a little deeper and it's clear that both Argentina and Turkey are emerging market outliers nursing self-inflicted wounds. Their financial woes - which also includes damage to the credibility of their central banks - are far from representative. And this, coupled with an improvement in Chinese economic conditions, is why we remain overweight local currency EM debt.

GRAB A BARGAIN
EM currencies' deviation from fair value



Data covering period 31.12.1979-28.09.2018. Source: Thomson Reuters Datastream, Pictet Asset Management

The current account positions of developing economies, for instance, have in fact improved considerably since 2013.

In aggregate, emerging nations' current account surplus has grown from 0.1 per cent to 0.8 per cent of GDP over that time.

Even among emerging countries with deficits, the gap has narrowed to 1.7 per cent of GDP compared with almost 4 per cent during the taper tantrum of 2013, when markets wobbled after the Fed signalled its readiness to scale back quantitative easing.

What is more, inflation across the emerging world has remained well below its long-term average and continues to fall. Currently, prices are rising at some 3 per cent per year, almost 2 percentage points below the average pace of the past two decades, with the rate having moved lower in almost uninterrupted fashion since 2012.

Taking all this into account, EM currencies and bonds look cheap. EM local currency bonds yield more than 6.5 per cent on average — a 300 basis point premium over high yield debt — while their currencies are, according to our calculations, trading at more than 20 per cent below fair value (see chart).

Further reinforcing our stance are signs that the US dollar’s appreciation is losing steam.

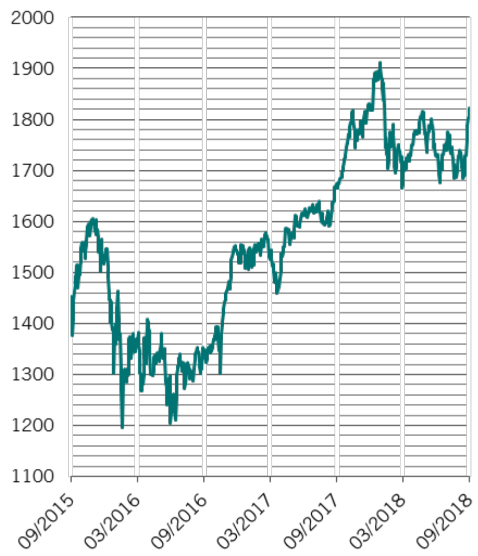
04

Global markets overview: Tokyo stocks shine

Equities eked out slim gains in September, outperforming bonds, which fell 0.7 per cent. Expectations that the damage from the US-China trade war would be contained and hopes that Beijing will pump more money into its economy underpinned stocks.

In the US, the S&P 500 index hit an all-time high, posting the best quarterly performance since 2013 and bringing this year's gains to over 10 per cent. Stronger-than-expected corporate earnings and a high volume of share buybacks have been driving the market higher. A rally in oil prices helped lift energy-related stocks, whose returns bettered those of other equity sectors.

POWERING AHEAD
TOPIX price index



Source: Thomson Reuters Datastream. Data covering period 25.09.2015 – 25.09.2018

Japanese stocks rose the most among the regions, adding more than 5 per cent as a weakening yen and expectations for more equity buying from the Bank of Japan helped lift the benchmark Nikkei average to a 27-year high.

US Treasuries had their worst month since January, with the benchmark 10-year yield briefly hitting a four-month high above 3 per cent as rising government debt supply and expectations for more interest rate hikes from the Fed encouraged investors to switch out of the asset class.

Emerging stocks fell across the board as jitters over higher US interest rates and concerns about India's shadow banking sector accelerated investor outflows.

The dollar ended the month up 1 per cent. The dollar’s gains were especially pronounced against the yen, where it hit a nine-month high.

05

In Brief

BAROMETER OCTOBER 2018

Asset allocation

We're maintaining our neutral weightings on equities, bonds and cash.

Equity sectors and regions

We continue to favour Japan over US, and turn less negative on the global utilities sector.

Fixed income and currencies

We like emerging market bonds and local currencies.