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| **From rout to recovery – Luca Paolini, Pictet Asset Management** |
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“October proved a cruel month for equities,” says **Luca Paolini**, c**hief strategist** at **Pictet Asset Management**.

“Yet, there is plenty of scope for stocks to stage a recovery, which is why we have raised our allocation to equities to overweight from neutral, and downgraded bonds to underweight.”

“Whilst it is true that the equity bull market of much of the last decade had gone too far, so too did October’s sharp correction.”

“That sharp repricing of stocks has taken equity valuations to below their average of the past three decades for the first time in two years – a shift that is at odds with fundamentals.”

“Cyclical and emerging market (EM) stocks are likely to benefit most from this short-term bounce. Although global economic growth and corporate earnings are already rolling over from their peak earlier in the year, history tells us it’s even more damaging to sell out of the last, frothy stage of a bull cycle than it is to sell too late.”

“Some of the biggest losers during recent months were global cyclical stocks. They are now the most oversold companies in seven years, which has opened up pockets of value.”

“As a result, we retain our preference for inexpensive cyclical markets, particularly emerging markets and the considerably undervalued Japan stock market.”

“Asian markets represent particularly good value, having been battered by concerns about trade wars and a slowdown in China.”

“Any signs of a rapprochement between the US and China on tariffs - which may emerge in November – could spark a revival in EM stocks.”

“Meanwhile, we have raised industrial stocks to overweight following the sector’s recent selloff, whilst we’ve downgraded information technology to underweight. Even after lurching lower, the sector remains very expensive and growth stocks will continue to come under pressure if, as we expect, bond yields continue to rise.”

“We still like late-cycle cyclical sectors such as energy and mining, as well as health care. By contrast, rising inflation and interest rates should prove a headwind for consumer discretionary stocks – indeed, house builders and car makers are already starting to struggle.”

“The stars are also aligned for a recovery in local currency emerging market debt. Some of the market’s re-evaluation of EM bonds and currencies was justified. But just as the market had rallied too hard in 2017, it has pulled back too much since. Economic prospects may look less rosy, but they're still positive.”

“EM policymakers have largely responded well to the turmoil. Meanwhile, flexible exchange rates have helped to absorb the shocks. Hence, most EM economies weathered the storm largely unscathed.”

“More broadly, the premium offered by EM debt now looks attractive. Emerging market currencies are the cheapest they’ve been relative to the dollar in at least two decades. Portfolio flows into EM assets have also been improving in recent weeks – a trend which we expect to continue and offer further support to the asset class.”

“Elsewhere in fixed income, we find the prospects for developed market credit uninspiring, particularly among non-investment grade issuers. We are concerned about the impact US rate hikes might have on firms that borrowed heavily during the era of easy money.”

“So far, markets have yet to discount the possibility of a credit crunch – both investment grade and high yield markets have proved rather resilient even though outflows from funds holding such bonds have picked up sharply in recent weeks.”

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## Note to Editors

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