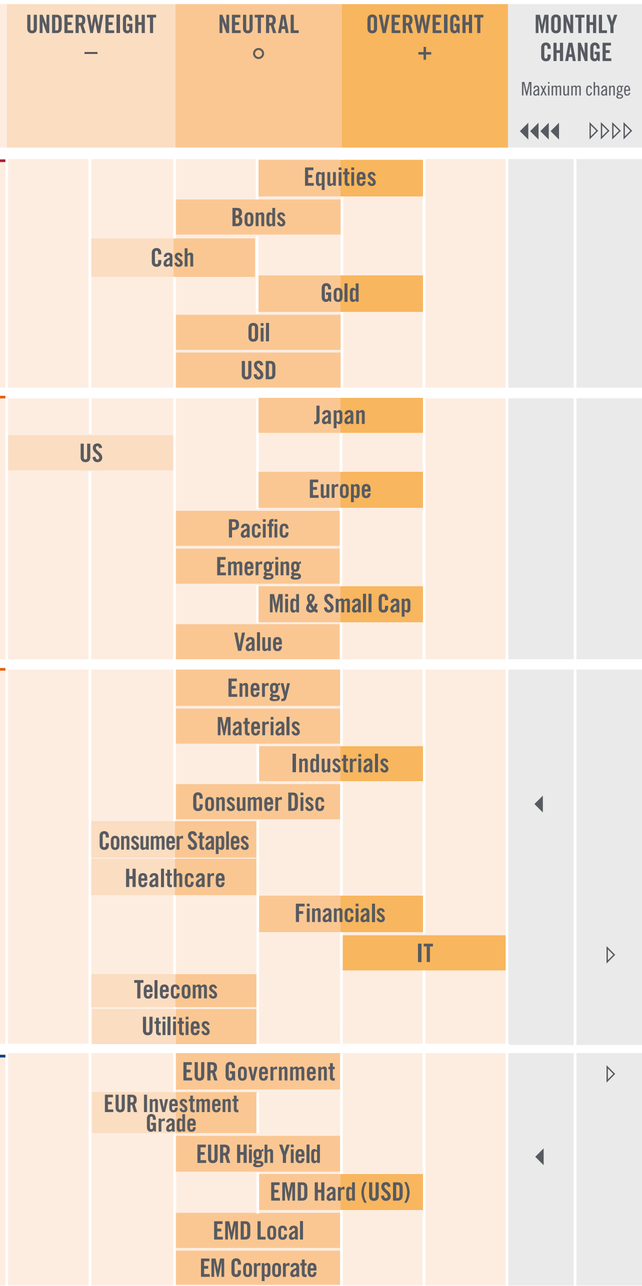
PICTET 1805




**GLOBAL ASSET CLASSES**
We retain our overweight stance on equities partly because corporate earnings prospects are improving worldwide.

**EQUITY REGIONS AND STYLES**
We remain overweight European and Japanese stocks; although neither market is cheap, both should benefit from improving economic growth.

**EQUITY SECTORS**
We continue to prefer cheap cyclical sectors; we reduce consumer discretionary to neutral on valuation grounds and raise exposure to IT.

**FIXED INCOME**
We scale back exposure to high-yield following the market's strong gains, and increase our holdings of long-dated Italian and Spanish government bonds.

# Earnings recovery to keep rally going

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

# Barometer

June 2015

# Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 1 June 2015

## Global market overview

### Greek jitters and US rate outlook keep markets on edge

*Developed market stocks outpaced bonds in May after US economic indicators reinforced expectations that the US Federal Reserve will raise interest rates later this year. The US dollar rallied, recording sharp gains against the euro as fears of a Greek default persisted.*

*Global government bond markets witnessed one of their steepest four-week declines on record as a combination of technical and fundamental factors sent yields higher on both sides of the Atlantic (see chart).*

*The correction came amid signs of rising inflation in the US and growing concerns that bond valuations were becoming stretched. The selloff may have been amplified by a lack of liquidity in the secondary bond market - a symptom of reduced market-making activity among banks.*

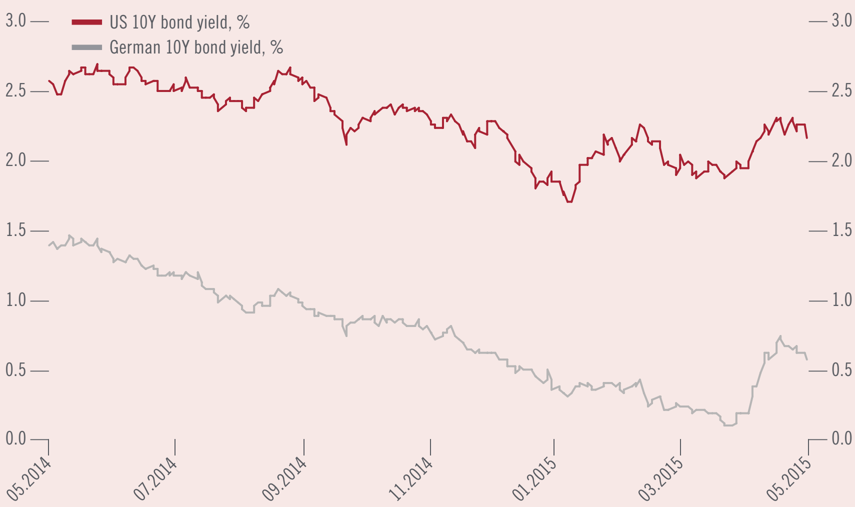
*Political uncertainty remained high in Europe amid persistent worries that Greece may not reach an agreement on reforms with its creditors. The Greek government is due to make a EUR300 billion debt repayment to the IMF on 5 June. Greek tensions kept a lid on European equity markets and left the euro on the back foot.*

*China was another source of volatility in the last days of the month as its equity market tumbled, halting an advance of nearly 50 per cent this year. The Shanghai index lost 6.5 per cent on 28 May on record turnover after brokerages tightened lending restrictions and the central bank took measures to drain excess liquidity from the financial system.*

*Emerging market currencies and commodities retreated, weighing on emerging market equities and local currency bonds. The rebound in the US dollar put downward pressure on many currencies in both the developed and developing world.*

*The Japanese yen dropped to a 12-year low against the greenback, highlighting the divergence in the countries' monetary policies.*

STRONG SELLOFF IN LONG-DATED US AND GERMAN GOVERNMENT BONDS




Source: Thomson Reuters Datastream

## Asset allocation

### Equities remain the asset class of choice

Equity markets look set to build on their gains over the near term as loose monetary policy and the prospect of an improvement in economic growth should continue to support a recovery in corporate earnings, particularly in Europe and Japan. We consequently retain our overweight stance on global stocks and remain neutral on bonds.

Although the risk of a correction has risen in recent weeks – not least because the rally is being fuelled by an ever-narrower range of stocks – many of the gauges we monitor suggest the market's positive momentum will remain in place for a few months.

Our **business cycle** readings show the global economy suffered a setback last month, with activity in both the developed and developing world slowing. Nevertheless, there are reasons to expect conditions to improve over the coming quarters.

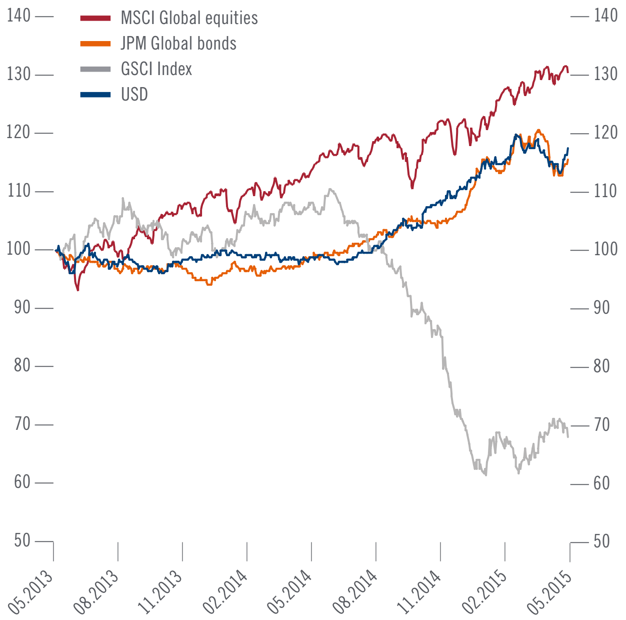
The European economy remains firmly in expansion mode, with countries in the region's periphery outpacing Germany. While industrial production has been expanding at a slower rate in Germany in recent months, the opposite has been true in countries such as Spain, Italy and France. Credit growth is also a feature of the euro zone economic landscape. Loans to households are gathering pace while the money supply (M3) is expanding at its fastest rate since 2009. Although these positive developments are threatened by Greece's possible exit from the euro zone, we are cautiously optimistic on the prospect of a short-term funds-for-reform compromise between Athens and its creditors.

In Japan, meanwhile, economic prospects remain encouraging on the whole. Business and consumer sentiment readings are both positive. And even though consumer spending has disappointed, business investment has continued to expand.

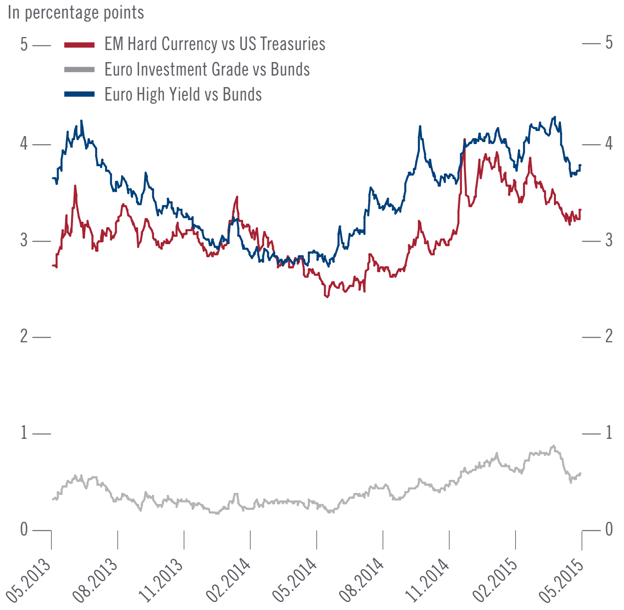
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

## MAJOR ASSET CLASSES

### PERFORMANCE: ASSET CLASSES

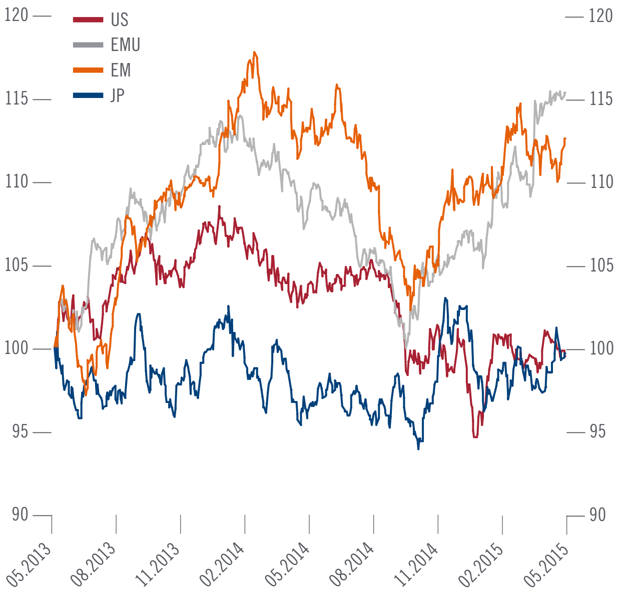



### BONDS: ASSET CLASS SPREADS

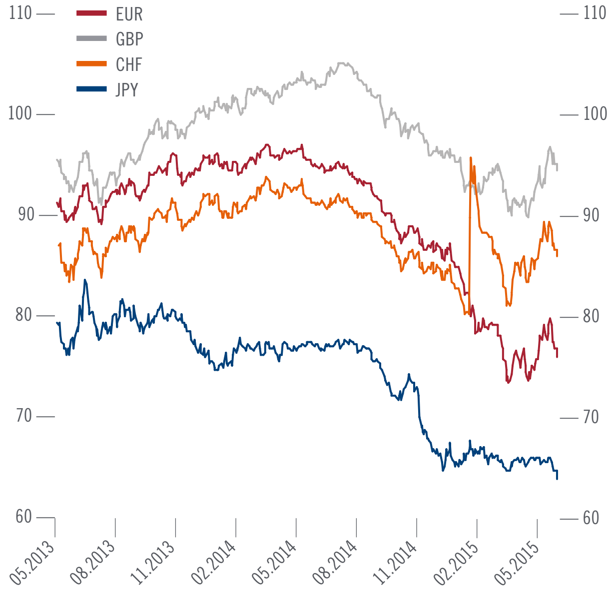



## EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE

### GLOBAL EQUITY SECTOR ROTATION: PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS

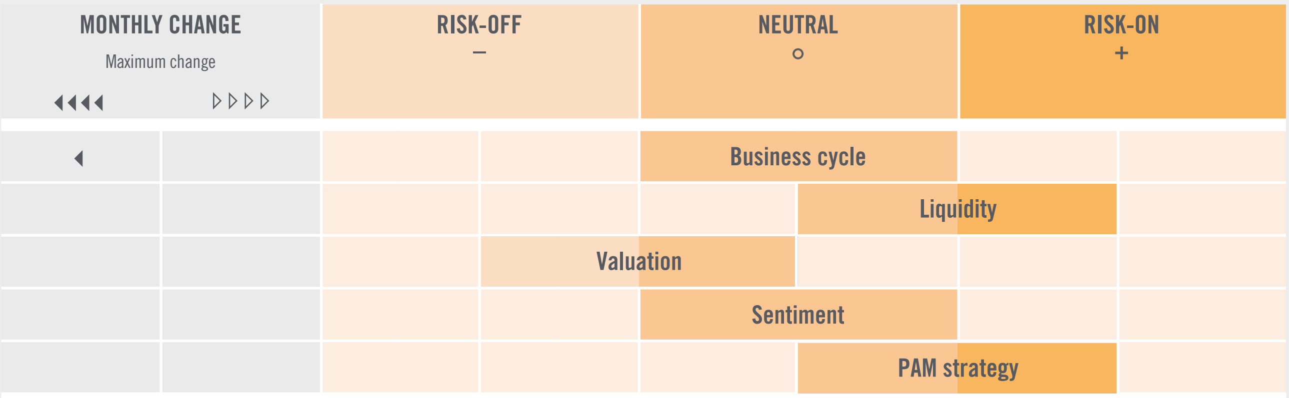



### PERFORMANCE: CURRENCIES VS USD



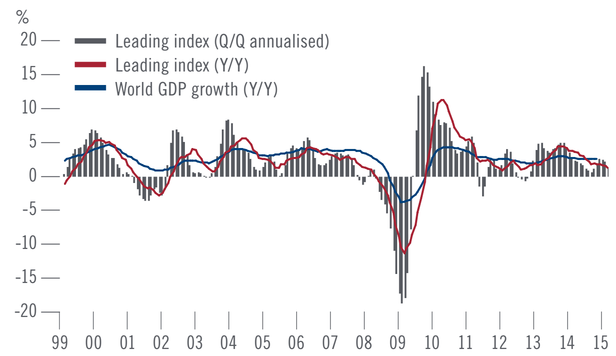
Source: Pictet Asset Management, Thomson Reuters Datastream

## RISK BIAS INDICATORS

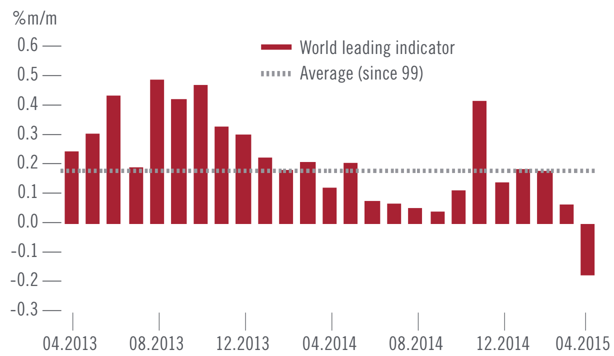



## BUSINESS CYCLE: WORLD ECONOMIC GROWTH REMAINS SUBDUED

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

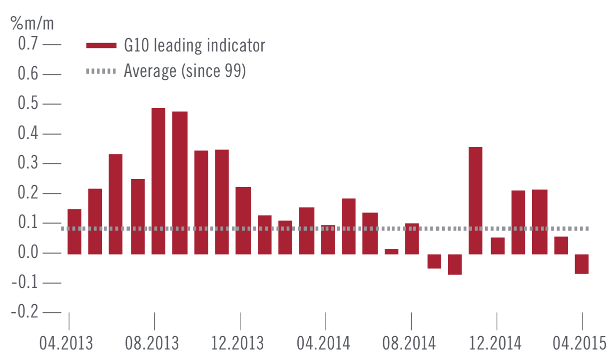



WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

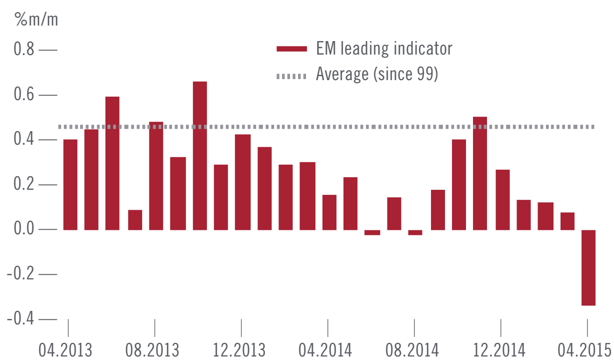



## ECONOMIC MOMENTUM SLOWS DOWN ACROSS THE WORLD

G10 LEADING INDICATOR M/M GROWTH




EM LEADING INDICATOR M/M GROWTH



Source: Pictet Asset Management, Thomson Reuters Datastream

## VALUATION: EQUITY MARKETS AND SECTORS

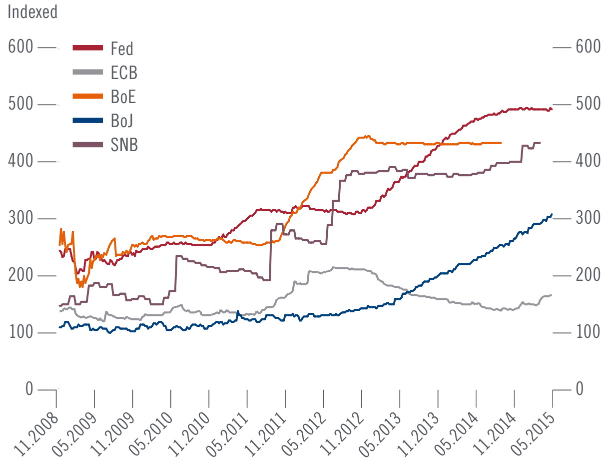
COUNTRIES AND SECTORS

| MSCI REGIONS | EPS GROWTH 2015 | EPS GROWTH 2016 | SALES GROWTH 2015 | SALES GROWTH 2016 | PE 2015 | PE 2016 | PB 2015E | P/SALES 2015E | DY 2015E |
|---|---|---|---|---|---|---|---|---|---|
| US | 1% | 12% | -2% | 6% | 18.0 | 16.1 | 2.7 | 1.9 | 2.0% |
| Europe | 4% | 12% | -1% | 5% | 16.8 | 14.9 | 1.9 | 1.3 | 3.3% |
| EMU | 17% | 13% | 3% | 4% | 16.5 | 14.6 | 1.7 | 1.1 | 3.0% |
| Switzerland | -4% | 9% | -1% | 4% | 18.8 | 17.3 | 2.7 | 2.5 | 3.0% |
| UK | -10% | 13% | -8% | 7% | 16.9 | 14.9 | 1.9 | 1.3 | 3.8% |
| Japan | 16% | 9% | 7% | 3% | 16.2 | 14.9 | 1.5 | 0.8 | 1.8% |
| EM | 5% | 13% | 0% | 8% | 12.8 | 11.4 | 1.5 | 0.8 | 2.7% |
| NJA | 11% | 10% | 1% | 8% | 13.3 | 12.1 | 1.5 | 0.8 | 2.5% |
| **Global** | **3%** | **13%** | **0%** | **6%** | **17.3** | **15.4** | **2.1** | **1.4** | **2.4%** |

| MSCI GLOBAL SECTORS | EPS GROWTH 2015 | EPS GROWTH 2016 | SALES GROWTH 2015 | SALES GROWTH 2016 | PE 2015 | PE 2016 | PB 2015E | P/SALES 2015E | DY 2015E |
|---|---|---|---|---|---|---|---|---|---|
| Energy | -46% | 32% | -24% | 12% | 21.7 | 16.5 | 1.3 | 0.8 | 3.4% |
| Materials | -4% | 19% | -3% | 4% | 17.7 | 14.9 | 1.9 | 1.0 | 2.7% |
| Industrials | 9% | 11% | 6% | 4% | 17.3 | 15.6 | 2.5 | 1.0 | 2.3% |
| Consumer Discretionary | 15% | 14% | 6% | 6% | 18.0 | 15.7 | 2.9 | 1.2 | 1.8% |
| Consumer Staples | 1% | 9% | 4% | 5% | 21.0 | 19.2 | 3.9 | 1.3 | 2.6% |
| Health care | 9% | 12% | 7% | 6% | 19.8 | 17.7 | 4.0 | 2.2 | 1.8% |
| Financials | 12% | 10% | 6% | 5% | 13.3 | 12.1 | 1.3 | 1.8 | 3.0% |
| IT | 9% | 11% | 6% | 5% | 17.1 | 15.4 | 3.2 | 2.3 | 1.6% |
| Telecoms | 7% | 9% | 3% | 3% | 16.8 | 15.4 | 2.3 | 1.4 | 4.0% |
| Utilities | 8% | 0% | 0% | 2% | 15.0 | 15.0 | 1.5 | 1.0 | 3.8% |

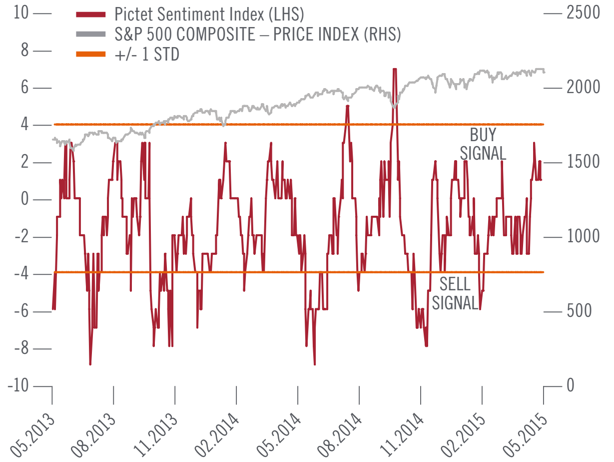
## LIQUIDITY: FED ENDS QE BUT MONETARY STIMULUS CONTINUES ELSEWHERE

SIZE OF CENTRAL BANKS' BALANCE SHEETS




## SENTIMENT INDICATOR BACK IN NEUTRAL GEAR

PICTET SENTIMENT CYCLE INDEX



In the US, the picture is more mixed. US manufacturing is unusually sluggish, with production having contracted in April. Comparing the three months to April 2015 with the previous three-month period, manufacturing output fell an annualised 1.8 per cent, the worst reading outside recession since 1989. While retail sales rose for the second month in a row, the rebound has been weaker than expected, suggesting that households are still choosing to save – rather than spend – the windfalls they have received from lower energy bills. The employment picture is more encouraging. Bearing testimony to the improvement in labour markets is a 2.8 per cent annual increase in US private sector wages. We believe US economic growth could rise up above 2.5 per cent in the second quarter.

Emerging markets growth has meanwhile fallen victim to a marked slowdown in China. The Chinese economy has seen both export demand and domestic consumption hit an air pocket. Credit availability has also been curtailed, weighing on the property market and construction activity. In our view, the deterioration in Chinese business conditions will at some point prompt a more decisive response from the authorities, who have the financial wherewithal to deliver a stronger monetary and fiscal stimulus than they have committed to thus far. Outside China, conditions do not seem encouraging. India has recently experienced a loss of momentum while export-oriented economies have yet to see any real benefit from a persistent decline in their currencies.

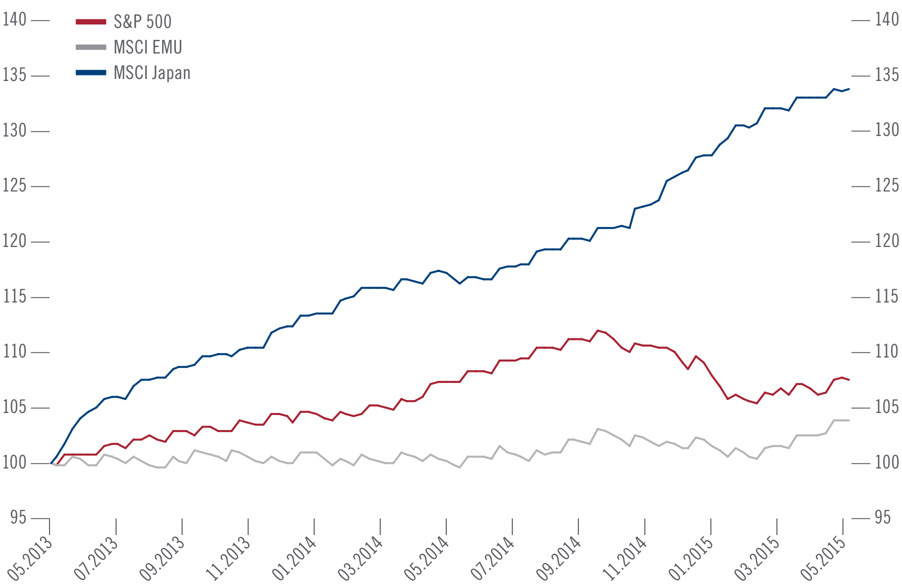
While **liquidity** conditions in the global financial system are not as buoyant as they were in the first quarter of this year, they should be strong enough to support equity markets over the next two to three months. The gauges we monitor remain especially positive for the euro zone, where the availability of credit is expanding thanks to European Central Bank quantitative easing.

Our **sentiment** readings give conflicting signals. A negative for riskier asset classes is the shallow nature of the stock market rally. Gains are increasingly concentrated in a narrow range of industry sectors and stocks, suggesting this period of bullishness might soon end. Offsetting that are positive developments in investor positioning. Retail investors remain cautious and have cut back their holdings of equities over the past several weeks, placing some of the proceeds from those sales into cash. These funds are, in our view, unlikely to stay in cash for long and could once again flow back into stocks should economic data improve.

Our **valuation** gauges continue to show that most asset classes are expensive in absolute terms. Trading at around 16 times prospective earnings, equities are at the high end of their ex-bubble range. But a different picture emerges when the focus shifts to relative valuations. Viewing developments through this lens, equities continue to offer better value than bonds. Bonds' risk premia – the compensation they offer investors against the risk of inflation (inflation premia) or an erosion of a bond issuer's credit profile (credit premia) – are low by historic standards. In contrast, stocks' equity risk premium – the extra compensation investors are offered for taking on more risk[1] – is still above the long-term average. What is more, stock valuations also appear favourable when set against trends in corporate earnings. As the chart shows, corporate profits are recovering in many parts of the world with the notable exception of emerging markets.

EARNINGS GROWTH RISING WORLDWIDE

12-month forward earnings per share growth, indexed




Source: Thomson Reuters Datastream

[1] The equity risk premium = internal rate of return of S&P constituents – US Treasury yield. Internal rate of return calculated discounted cashflow forecast for US S&P 500 constituents, which assumes US corporate earnings grow in line with current consensus estimates over the five years t 31.03.2020. Forecast also assumes a dividend payout ratio of 45 per cent.

## Equity region and sector allocation

# Europe and Japan favoured; overweight IT sector

We keep our regional allocation unchanged – we are overweight Europe and Japan and cautious on the US and emerging markets.

European and Japanese stocks stand to benefit from continued central bank support.

Quantitative easing by the ECB has reignited growth in Europe, which until recently had been propped up by Germany. Data for the first quarter of the year showed that the economic recovery has strengthened in tandem with a change in the composition of growth as the pace of activity picked up smartly in France, Spain and Italy.

There is also increasing evidence that QE is having a beneficial impact on credit markets, where household and business lending is accelerating. With the additional impact of a weaker euro, the conditions are set for an improvement in corporate earnings in the region, which should, in turn, push markets higher. Assuming corporate earnings in Europe return to more normal levels, the market does not look particularly expensive.

Japan is another region where corporate earnings growth is healthy and valuations are attractive. Surveys indicate that confidence is high among both consumers and businesses while hard data has confirmed that capital spending is building among Japanese corporations; private consumption has been slower to pick up but is expected to gather momentum later this year, underpinning the economic recovery. In the meantime, the Bank of Japan's easy monetary policy is a powerful support for domestic stocks, and the fact that inflation has remained stubbornly below its 2 per cent target could encourage the central bank to increase the size of its stimulus, which would provide an additional boost to equity markets.

The Japanese market is also supported by favourable structural trends. Following the government's efforts to improve corporate governance, a rising number of companies are rewarding shareholders through buybacks and dividend payments. In the 12 months to March this year, dividends have climbed 76 per cent to USD104 billion.

US stocks exhibit lofty valuations when compared to other developed equity markets. This looks hard to justify at a time when the strength of the US dollar begins to bite into the profits of exporters. Although sluggish economic growth has reduced the probability of an imminent rise in US interest rates, a tightening labour market and the rebound in housing suggest pressures on the Fed are building. The bottoming out of core inflation should, together with these other factors, conspire to push the Fed into raising rates before the end of the year. We therefore keep US equities at a full underweight.

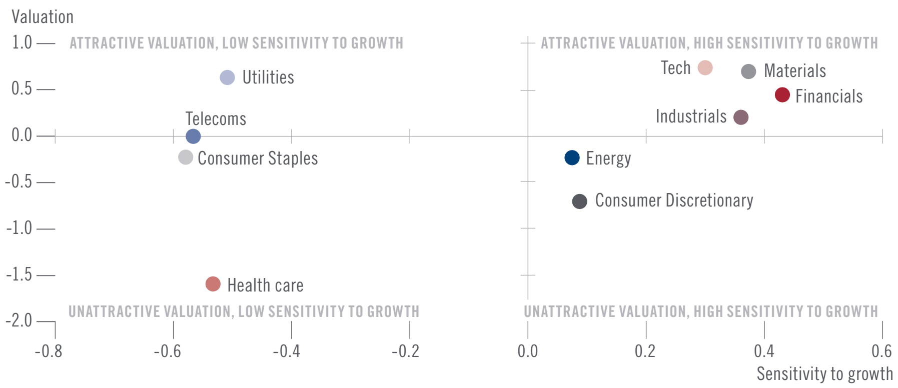
Emerging market equity valuations are attractive, especially for Asian stocks, but uncertainty over the outlook for corporate earnings prevent us from increasing our exposure to the asset class. The latest data from China, in particular, shows the economy remains sluggish and that the country may need more aggressive stimulus measures to avert a more pronounced slowdown.

In our sector allocation, we keep our preference for attractively-valued sectors most likely to benefit from strengthening global economic growth (see chart). The technology sector's prospects look particularly good and we upgrade it to a full overweight. The tech sector now trades at a discount to the global equity market based on prospective earnings. To us, this valuation gap is unwarranted as tech stocks are expected to deliver 30 per cent more earnings growth than other sectors over the next five years. Companies operating in the sector are also better equipped to hold up in a rising rate environment because they are cash rich.

We downgrade consumer discretionary stocks on valuation grounds. With global retail sales losing momentum, it is difficult to see the sector outperform.

PREFERENCE FOR CHEAP CYCLICALS

Valuation vs sensitivity to growth*, by industry sector




Source: Thomson Reuters Datastream, Pictet Asset Management

*Valuation: z-score base on our proprietary valuation scorecard; sensitivity to growth measures a stock sector's correlation with the US Institute of Supply Management Purchasing Managers Index over a 10-year period; each sector's correlation is expressed as a standard deviation from the MSCI World Index's correlation with the ISM. )x

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## Fixed Income

# Scaling back high yield; government bond markets a rich hunting ground

With European speculative-grade fixed income securities having returned about 3 percentage points more than government debt so far in 2015 we believe it makes sense to scale back our exposure to high-yield bonds to neutral. We also upgrade sovereign debt to neutral from underweight.

Although high yield bonds should draw support from the euro zone's economic recovery and the ECB's heavy dose of monetary stimulus, the asset class's yield spread looks increasingly unattractive compared to that offered by either Italian or Spanish sovereign debt.

Amid the recent sell-off in government bonds, the yield gap between Italian and German sovereign debt widened by about 50 basis points. Similar shifts have occurred in Spanish bond markets. In our view, these yield differentials are unjustifiably high, particularly as the ECB remains focused on keeping a lid on the borrowing costs of economies in the euro zone's periphery. As such, we are overweight long-dated Italian and Spanish government bonds. More broadly, we believe government bond markets could evolve into a rich hunting ground for tactically-oriented investors over the coming months as market interest rate expectations are becoming increasingly volatile. As the chart shows, the market's view on the timing of the ECB's first rate hike has swung violently over the past several weeks. This has partially corrected the valuation anomaly in European government bond markets – where longer-dated yields had been discounting the prospect of a prolonged period of exceptionally low inflation.

Our only overweight is in US dollar emerging market bonds. The asset class continues to offer an attractive yield pick-up over US Treasuries of some 380 basis points, which is wide by historical standards.

Also positive for the asset class are supply and demand dynamics. Dollar denominated emerging market bonds have proved popular with retail investors over the past several months; mutual funds have seen net inflows for 15 consecutive weeks. Institutional investors have also raised their exposure to the asset class in recent weeks.

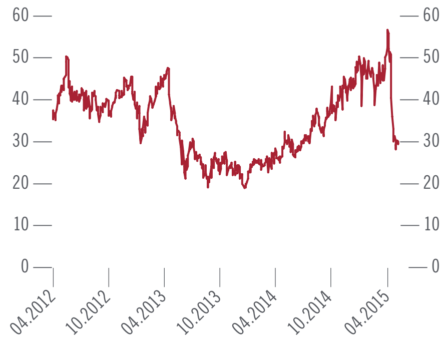
This rise in demand is occurring in tandem with a reduction in the net supply of bonds from sovereign borrowers. Over the remainder of 2015, emerging market governments are expected to issue USD43.6 billion of new debt, an amount that is entirely offset by the bond redemptions and coupon payments emerging market fixed income investors are due to receive in the same period.[2]

*Olivier Ginguené, Chairman*
*Pictet Asset Management Strategy Unit*

*Luca Paolini, Chief strategist*
*Pictet Asset Management*

INTEREST RATE EXPECTATIONS INCREASINGLY VOLATILE

Market's view on timing of first ECB rate hike, months from observation date




Source: Thomson Reuters Datastream

### ABOUT THE PSU

The Pictet Asset Management Strategy Unit (PSU) is the investment group responsible for providing asset allocation guidance across stocks, bonds, cash and commodities.

Each month, the PSU sets a broad policy stance based on its analysis of:

- **business cycle:** proprietary leading indicators, inflation
- **liquidity:** monetary policy, credit/money variables
- **valuation:** equity risk premium, yield gap, historical earnings multiples
- **sentiment:** Pictet sentiment index (investors' surveys, tactical indicators)

[2] Source: JP Morgan

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