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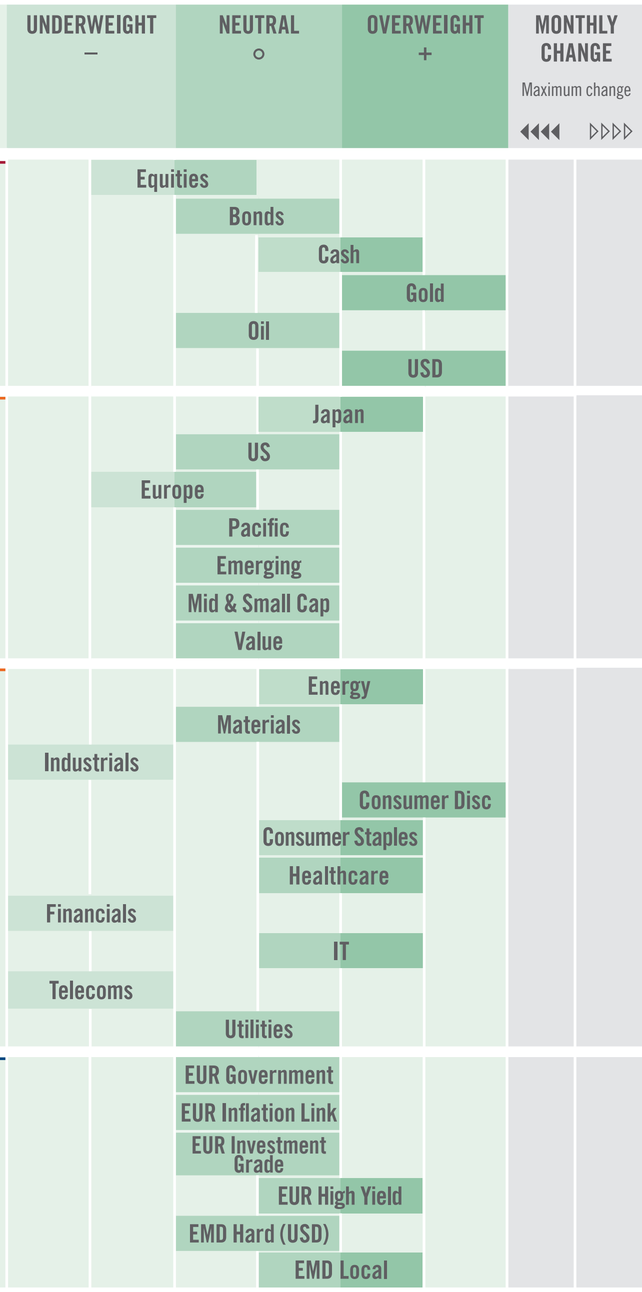


GLOBAL ASSET CLASSES

We stick to our underweight stance on equities and retain our overweight in cash as global economic growth remains sluggish and earnings forecasts are heading lower.

EQUITY REGIONS AND STYLES

We remain tactically overweight Japan as the market remains cheap and the new government is committed to further fiscal and monetary stimulus; European stocks, meanwhile, do not look attractive.

EQUITY SECTORS

We continue to prefer consumer discretionary stocks and defensive sectors with good growth prospects; we remain underweight financials, telecoms and industrials.

FIXED INCOME

We remain overweight emerging market debt and high-yield bonds as sluggish economic growth and low interest rates provide support for riskier fixed income asset classes.

Beware complacency as US fiscal fix falls short

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

January 2013

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 2 January 2013

Global market overview

Market sees tail risk easing

Riskier asset classes gained in December as US lawmakers closed in on a budget deal that would avert the fiscal cliff and the Federal Reserve upped the pace of its bond purchase programme to offset the winding down of Operation Twist. The approval of a new EUR34 billion aid package for Greece also boosted sentiment.

Japanese stocks were strong performers in local currency terms, with Liberal Democrat Party leader and quantitative easing advocate Shinzo Abe's victory in the country's general election raising the prospect of further monetary stimulus from the Bank of Japan. Emerging markets also fared well.

From a sector perspective, cyclical stocks outperformed their defensive counterparts – industrials, financials and materials saw the strongest gains while utilities and telecoms lagged.

Within fixed income, higher-yielding securities built on their recent gains as corporate high-yield debt and emerging market bonds continued to benefit from investors' appetite for yield. Government bond yields in Italy, Spain and Greece – whose credit rating was raised several notches by Standard & Poor's – fell to their lowest levels in several months. In the currency markets, some emerging market currencies saw healthy gains while the Japanese yen continued its descent as investors envisaged further monetary easing.

Asset allocation

Maintaining bearish stance as political risk and weak growth outweighs dovish policy moves

We retain a bearish stance on risk assets as signs of stronger growth in the US and China are overshadowed by weak economic activity elsewhere, elevated political risks in Washington and the eurozone and some negative technical indicators.

The **business cycle** gauges we monitor are now closer to neutral territory, although our global leading indicators suggest world growth will be sluggish in the first quarter of 2013. While the US provides some positive signals on economic activity – the housing sector and the labour market are among the bright spots – business sentiment and investment remain weak. The US budget agreement – which includes income tax hikes for those earning above USD 400,000 and a mild increase in capital gains and dividend taxes – has removed some uncertainty in the very short term. But by delaying decisions on public spending cuts for two months, US lawmakers have merely postponed the most difficult part of the budget negotiation process. Our base case scenario is for a budget agreement that will result in a fiscal tightening equivalent to 1.8 per cent of GDP compared to the 4 per cent contraction that would materialise in the absence of a deal. The uncertainty over US public spending cuts counter the Fed's new measures to boost the economy, which include increased mortgage bond purchases and a commitment to keep rates low until unemployment reaches 6.5 per cent – a target we believe could be hit by as early as 2014.

The eurozone remains in a mild recession and our leading indicators point to a further divergence in the economic fortunes of the core and peripheral countries in the first part of 2013, with Germany gathering momentum but Spain contracting at a faster pace. With this in mind, we expect the European Central Bank to cut the repo rate in the first quarter of 2013, and stand ready to shift to a negative deposit rate during the first half of next year, should conditions demand such a move.

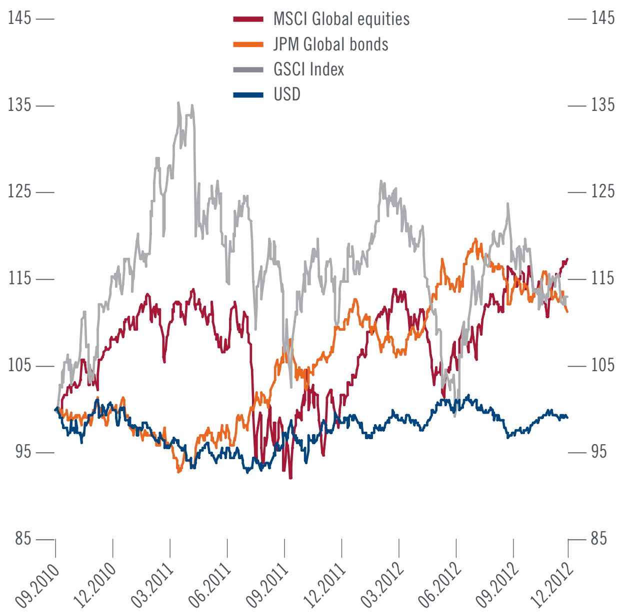
Political risks in the eurozone are still high even though borrowing costs for Italy and Spain have fallen to more manageable levels. Polls suggest Italian general elections – due to take place at the end of February following the unexpected resignation of prime minister Mario Monti – are unlikely to deliver a strong reform-minded government.

Economic developments in emerging markets are more encouraging, however, reinforcing our view that the low point of the business cycle was hit during the second quarter of 2012. China continues to see a recovery in growth (see chart) – construction activity in the country has improved for the past five months. Industrial production, retail sales and credit availability are also showing positive momentum.

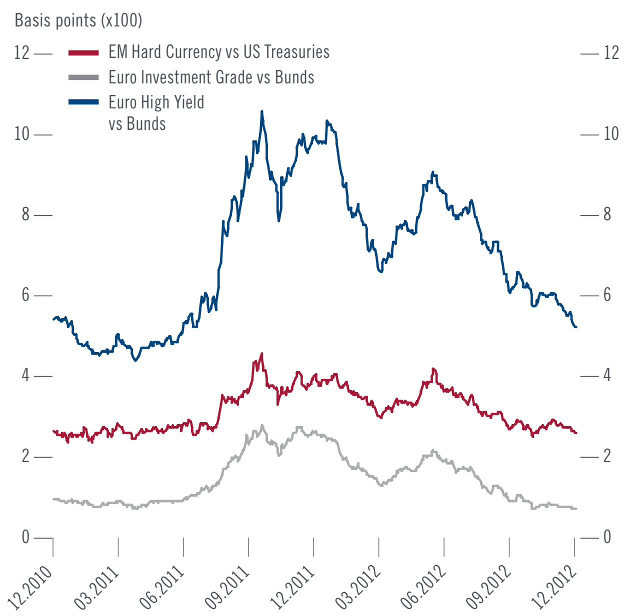
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

MAJOR ASSET CLASSES

PERFORMANCE: ASSET CLASSES

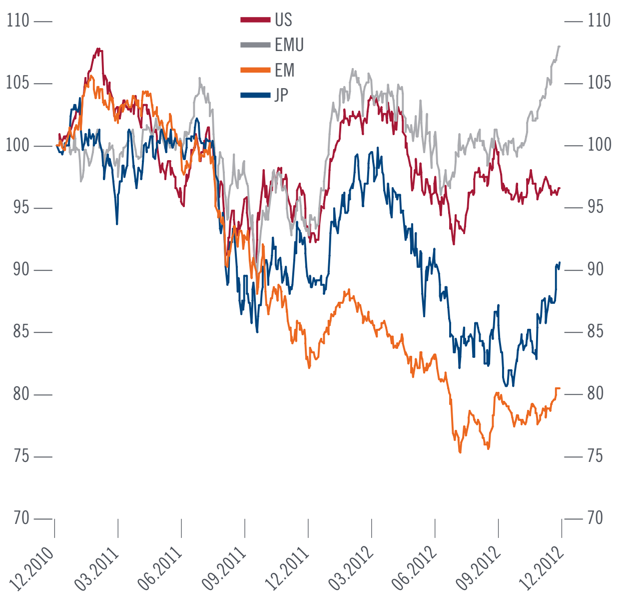


BONDS: ASSET CLASS SPREADS

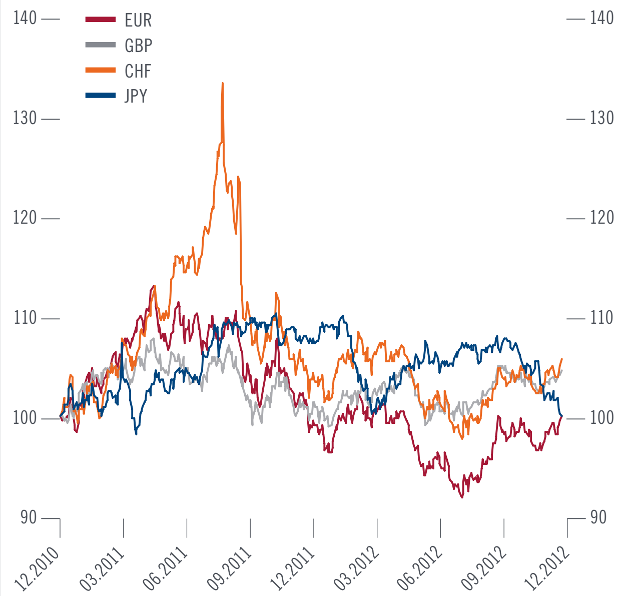


EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE

GLOBAL EQUITY SECTOR ROTATION:
PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS

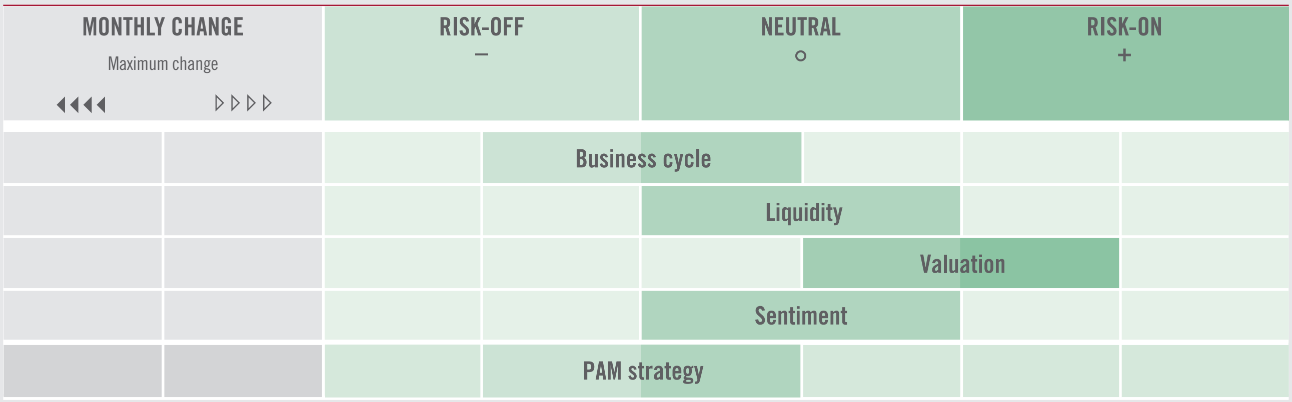


PERFORMANCE: CURRENCIES VS USD



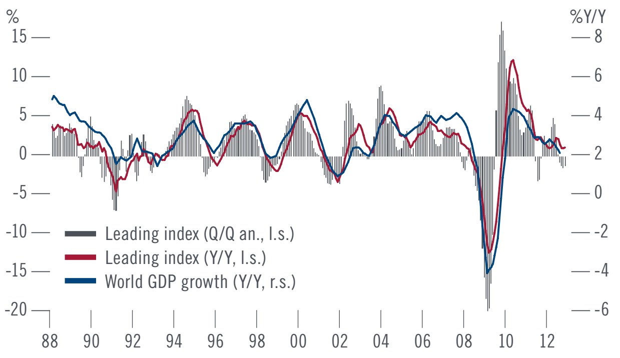
Source: Pictet Asset Management, Thomson Reuters Datastream

RISK BIAS INDICATORS: MONTHLY CHANGE

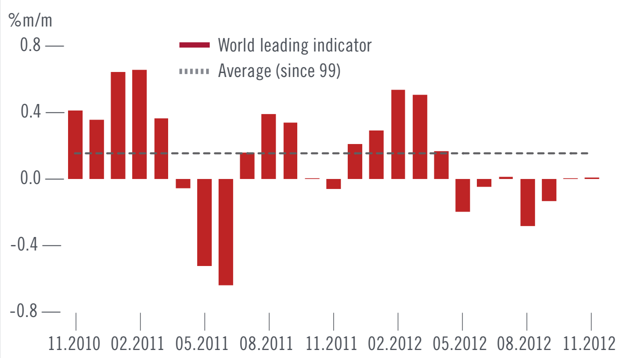


BUSINESS CYCLE: WORLD ECONOMIC ACTIVITY REMAINS WEAK

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

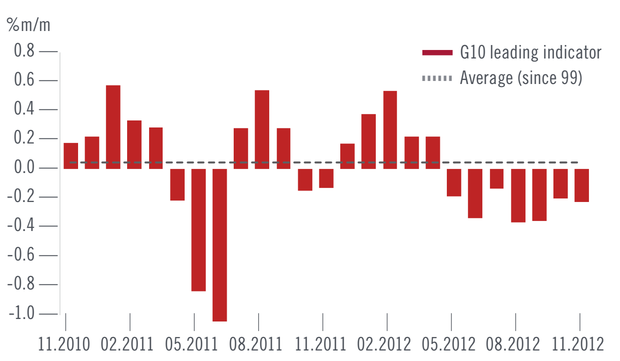


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

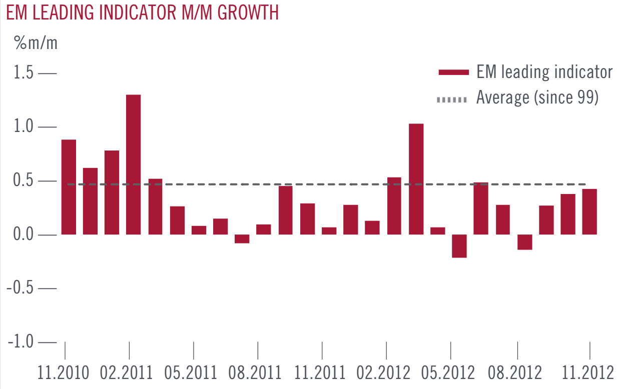


G10 & EMERGING COUNTRIES LEADING INDICATORS SUGGEST GROWTH YET TO RECOVER

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



Source: Pictet Asset Management, Thomson Reuters Datastream

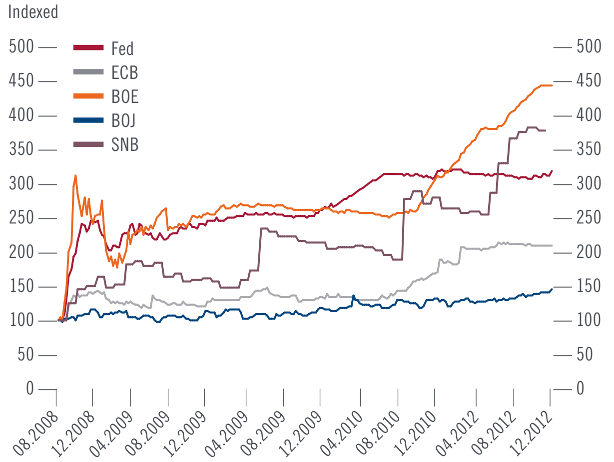
VALUATION: EQUITY MARKETS AND SECTORS

COUNTRIES AND SECTORS

MSCI	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
REGIONS	2012	2013	2012	2013	2012	12M	2012E	2012E	2012E
US	6%	9%	4%	4%	14.0	12.7	2.1	1.3	2.1%
Europe	-3%	9%	2%	3%	12.4	11.3	1.5	0.9	3.7%
EMU	-3%	10%	3%	3%	12.5	11.3	1.3	0.7	3.6%
Switzerland	6%	11%	5%	6%	14.9	13.4	2.2	1.9	3.2%
UK	-8%	7%	-1%	2%	11.5	10.7	1.7	1.0	3.9%
Japan	38%	36%	2%	3%	16.1	12.7	1.0	0.5	2.4%
EM	4%	13%	11%	5%	11.8	10.5	1.6	0.8	2.7%
NJA	9%	13%	12%	5%	13.0	11.4	1.6	0.7	2.5%
Global	4%	11%	5%	4%	13.5	12.1	1.7	1.0	2.7%
MSCI	**EPS GROWTH**		**SALES GROWTH**		**PE**		**PB**	**P/SALES**	**DY**
GLOBAL SECTORS	2012	2013	2012	2013	2012	12M	2012E	2012E	2012E
Energy	-9%	5%	1%	0%	10.5	10.0	1.4	0.6	3.1%
Materials	-21%	20%	0%	6%	14.6	12.1	1.6	1.0	2.5%
Industrials	5%	11%	4%	5%	14.0	12.7	1.9	0.7	2.6%
Consumer Discretionary	31%	17%	7%	5%	15.4	13.3	2.2	0.9	1.9%
Consumer Staples	6%	10%	8%	6%	17.4	15.7	3.2	1.0	2.8%
Health care	3%	7%	6%	5%	14.0	13.1	2.8	1.5	2.6%
Financials	8%	12%	4%	4%	12.0	10.7	1.1	1.4	3.2%
IT	11%	13%	4%	7%	13.9	12.2	2.6	1.5	1.4%
Telecoms	1%	8%	3%	2%	13.0	12.1	1.7	1.1	4.9%
Utilities	16%	12%	3%	3%	15.6	14.3	1.2	0.8	4.6%

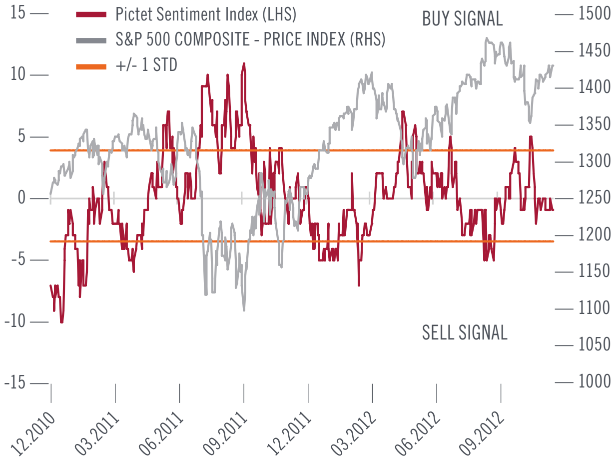
LIQUIDITY: BOOSTED BY EASY MONETARY POLICY

SIZE OF CENTRAL BANKS' BALANCE SHEETS



SENTIMENT: BACK TO NEUTRAL

PICTET SENTIMENT CYCLE INDEX



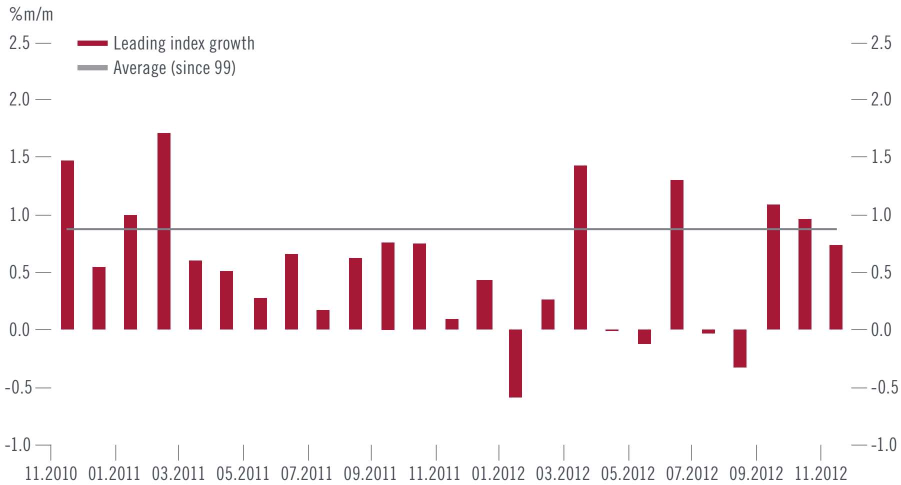
The weak spots in emerging markets remain Russia and India.

As far as **valuations** are concerned, equities are cheap relative to government bonds but on absolute, long-term valuation metrics such as Tobin's Q, cyclically-adjusted price/earnings ratios and price-to-sales ratios, they appear fairly valued at best. Moreover, corporate profit margins, while still above average, have accounted for an abnormally high 80 per cent of companies' earnings growth over the last three years and may not hold up much longer. There is therefore scope for further profit forecast cuts, which would make valuations even less appealing. Our profit model for the US suggests earnings growth of around 5 per cent for the next 12 months compared to a consensus forecast of 9.5 per cent.

Our **sentiment** readings also contain some negative signals for riskier asset classes. We are concerned that investors have become too complacent: the level of implied volatility – the cost of hedging against the risk of falling prices – has dropped to historically low levels in equity and fixed income markets. At the same time, while inflows into equities have been limited overall, some cyclical asset classes, such as emerging market stocks and bonds, have attracted strong flows in recent weeks and months.

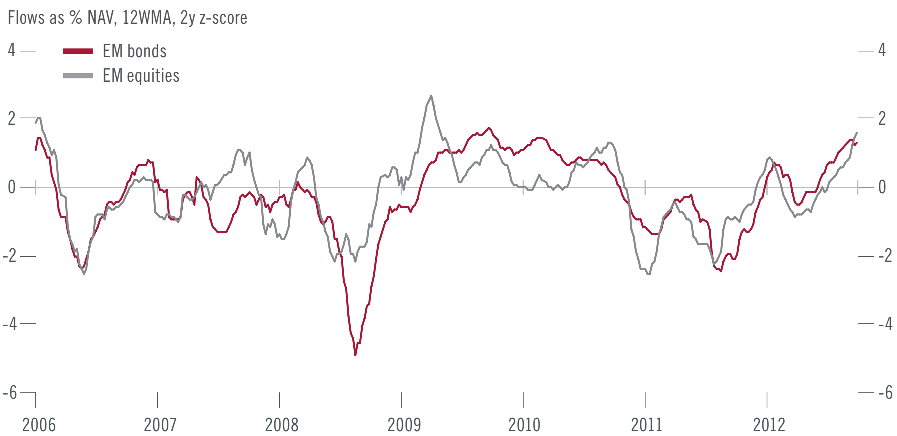
The **liquidity** signals we monitor suggest riskier asset classes have scope to make further gains. Excess liquidity – the difference between the annual growth rate of money supply and the rate of industrial production growth – points to an expansion in price-earnings ratios. Liquidity has been boosted by further growth in the balance sheets of the Fed and the BoJ. The Fed's new bond purchase programmes look set to increase the central bank's balance sheet by an amount equivalent to 6 per cent of GDP in 2013; for the BoJ, the increase will be closer to 9 per cent of GDP. By comparison, the ECB's monetary measures have been conservative.

CHINA A BRIGHT SPOT IN THE GLOBAL ECONOMY



Source: Pictet Asset Management

EMERGING MARKET EQUITIES AND BONDS CONTINUE TO SEE STRONG INFLOWS



Source: EPFR

Equity region and sector allocation

The tactical long on Japan remains in place

Of the world's major equity markets, Japan remains the most attractive in our view, and we stick to the overweight stance we adopted in November. Japanese equities are cheap on global basis, having lagged world equities over much of the past two years (see chart). The depreciation of the yen is another plus as it will boost the prospects of the country's large exporters.

This is especially the case for auto makers and technology companies, which have become far more competitive against their key Korean rivals following the yen's 20 per cent fall against the Korean won since June. Moreover, Japan is the country that exhibits the greatest potential for a positive shift in monetary policy. The new LDP-led government has called on the BoJ to adopt a more aggressive stance and to commit to the upper end of its current inflation target of 0 to 2 per cent.

We remain short European equities and neutral US stocks. With almost 40 per cent of the industry sectors in Europe trading at premium to their US counterparts, we believe European stocks are not cheap. Economic conditions are also unfavourable while upcoming elections in Italy could prove disruptive to policymakers' efforts to reverse the debt crisis. Liquidity conditions are also worsening for a growing number of countries in Europe, while corporate earnings prospects are weak. US stocks, meanwhile, still appear fairly valued on a range of long-term measures, while short-term corporate prospects remain hostage to political developments.

JAPAN HAS BEGUN TO OUTPERFORM GLOBAL STOCKS IN LOCAL CURRENCY TERMS

Source: Thomson Reuters Datastream

We continue to hold a neutral position in emerging markets but acknowledge that the case for shifting to a more constructive stance is building. Economic activity is gathering momentum, especially in China, while there are signs that earnings could recover as companies begin to implement cost cuts. The fact that more cyclical equities have begun to outperform defensive stocks is a bullish signal, although cyclical sectors in emerging markets continue to trade at a significant discount to defensive sectors.

On sectors, we retain the barbell strategy we initiated in late 2012 – holding an overweight in cheap cyclical sectors (information technology) alongside an overweight in defensive sectors. We stick to an overweight in consumer discretionary stocks as falling inflation, a rebound in the US housing sector and decent US employment growth should help boost consumption. We remain marginally overweight energy as the sector is cheap and offers an attractive dividend yield. Financials, industrials and telecoms are our biggest underweight positions.

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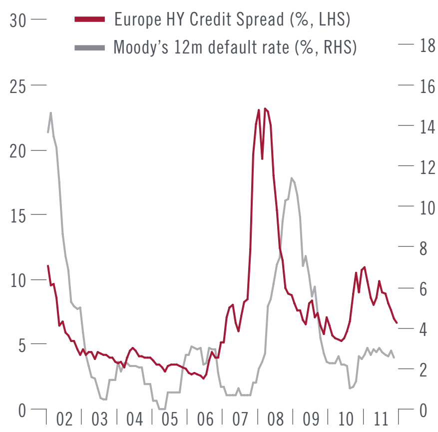
Fixed Income

Riskier asset classes remain in focus

HIGH-YIELD BOND INVESTORS REMAIN WELL COMPENSATED AGAINST DEFAULT RISK



Source: Thomson Reuters Datastream

The investment appeal of higher-yield fixed income assets such as speculative-grade corporate debt and emerging market sovereign bonds remains strong following an acceleration in the pace of monetary easing in both the US and Japan. Emerging market debt looks particularly attractive given that the base rate differential between developed and developing economies has widened over the course of the year to some 500 basis points. This rate gap should provide strong support for emerging market currencies, one reason why we favour local over dollar-denominated EM debt.

Corporate high-yield bonds are also attractively valued and remain an overweight. Spreads continue to offer investors ample compensation against the risk of default. Default rates in European markets are below average and are unlikely to rise by much over the medium term as many companies have managed to extend the duration of their liabilities and maintain high levels of cash on their balance sheets.

Companies' leverage ratios have begun to rise in aggregate as issuance has been strong. But given this increase comes from a very low level, it does not yet give cause for concern.

The technical backdrop is also favourable as demand for such paper is likely to remain high among retail investors on the lookout for yield.

As far as currency positioning is concerned we retain an underweight stance on both the euro and the Japanese yen. One of the most puzzling outcomes of the eurozone crisis has been the resilience of the euro – still trading at expensive levels against many developed market currencies. One reason for the currency's strength has been the perception that the ECB is less tolerant of inflation and more reluctant to engage in debt purchases than other central banks. According to this logic, eurozone real interest rates would remain higher than that those in US, providing the single currency with strong yield support. But with the ECB having committed to purchasing government bonds, and given our expectation for a rate cut in early 2013, the euro's yield support will likely erode, placing downward pressure on the currency. We are also short the Japanese yen. Although our bearish stance on the currency has borne fruit in recent weeks, we are inclined to maintain the position as the new LDP government is likely to put pressure on the BoJ to loosen monetary policy further.

Olivier Ginguené, *Chairman*
Pictet Asset Management Strategy Unit

Luca Paolini, *Chief strategist*
Pictet Asset Management

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, multiples vs. history
- **sentiment:** Pictet sentiment index (investors' surveys, tactical indicators)