

Growth picture improves but with political risks

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

March 2013

Monthly outlook

Pictet Asset Management
Strategy Unit

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Global market overview

Political risk returns

Nervousness returned to markets in February as inconclusive election results in Italy fuelled renewed concerns about the euro zone sovereign debt crisis, while investors worried the Fed might be ready to slow or stop its open-ended asset purchase programme. Equities fell modestly, bond yields declined and commodity prices corrected.

Although Fed Chairman Ben Bernanke assuaged fears by reaffirming his commitment to the Fed's stimulus efforts, the threat of sequestration underpinned US Treasuries. Federal spending cuts estimated at USD85bn for the current fiscal year were due to start on 1st March, with a potential impact on US growth of c0.5 per cent in case of full implementation – though we continue to consider this unlikely.

European equity markets were the weakest of the developed world. The political stalemate in Italy hit sentiment, which had improved on the perception that tail risk in the euro zone had receded. German bunds rallied and periphery bond spreads widened as investors shunned risk.

Japanese equities, by contrast, extended the rally started at the end of last year. The news of the appointment by the government of a dovish Bank of Japan governor and deputy sent the yen tumbling against the US dollar and boosted domestic stocks. Currency markets continued to be the focus of attention, with volatility in major currencies bringing renewed instability. The sterling fell sharply after Moody's stripped Britain of its triple-A rating – a move which compounded pressure on a currency already weakened by prospects of further monetary easing measures to boost the ailing economy. The euro weakened 4 per cent against the US dollar. In emerging markets, Turkey cut interest rates to stem the rise of the lira, while the South African rand gained.

Asset allocation

Moving to a neutral positioning while remaining mindful of risks ahead

We move to a more neutral stance by upgrading equities to equal weight and switching bonds to a small underweight as we take heart from an improvement in economic momentum, a slowdown in the pace of downward earnings revisions and more benign market sentiment readings. Although the global economic backdrop has improved, we are reluctant to adopt a fuller risk-on stance in the absence of a clearer buy signal from our contrarian sentiment reading, and with Europe hostage to political risks and US growth potentially constrained by fiscal tightening.

Our small downgrade of bonds reflects extended valuations, improving leading indicators and our belief that the long and slow process of bond yields normalisation has already started. We retain a long US dollar position, as the US economy is at a more advanced stage in the deleveraging cycle than the rest of the developed world.

Following the recent correction in equity markets, our **sentiment** readings have come down from extreme overbought levels and now stand in neutral territory. Measures of implied volatility – the cost of insuring against a market decline – have bounced back from record lows. However, some indicators still point to a degree of investor complacency. Fund flow surveys show strong inflows into equity funds since the beginning of the year – attesting to a strong risk-taking bias. Equity beta in hedge fund portfolios is also elevated.

Looking at **valuations**, global equities look fairly priced on a multiple of 12.5 times 12-month forward earnings. Longer-term metrics such as price-to-sales, Tobin's Q and cyclically-adjusted price/earnings ratio also point to a level close to fair value. Relative to bonds, equity valuations remain attractive. An encouraging sign is that consensus earnings growth estimates have been reduced to more realistic levels (8 per cent in the US, 5 per cent in the euro-area for this year, close to our own estimates), removing a big headwind for equity markets.

Our reading of the **business cycle** shows that the momentum is improving globally, led by developed economies. Global leading indicators rose for the second consecutive month after seven months in negative territory, confirming the recovery is becoming entrenched.

Economic activity has lifted in the US, with the strong recovery in business investment and industry orders up around 30 per cent on a 3-month annualized basis painting a more optimistic picture for the economy. At the same time, resilient consumer spending, a steady housing rebound and strong hiring indicate that growth might pick up in the current quarter. The biggest dark cloud over the US economy is the estimated USD85bn of sequestration cuts, as well as the lagged impact of the tax increases already implemented. Maintaining the current ultra-loose monetary policy will go some way towards offsetting the drag from

MAJOR ASSET CLASSES

PERFORMANCE: ASSET CLASSES

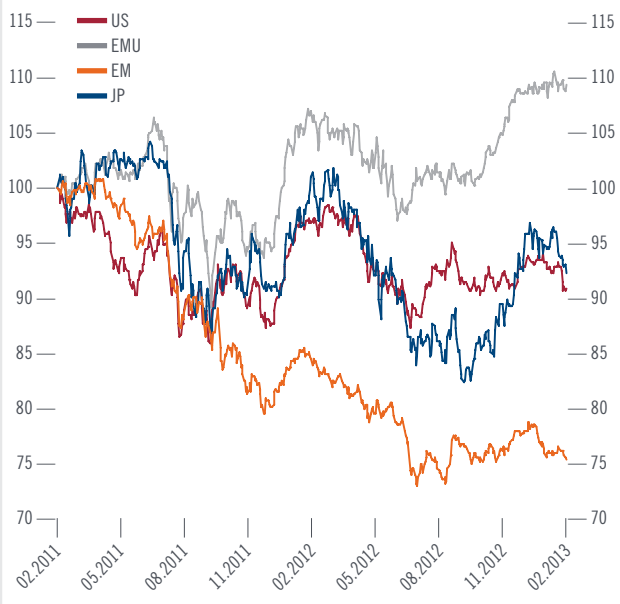


BONDS: ASSET CLASS SPREADS



EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE

GLOBAL EQUITY SECTOR ROTATION: PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS



PERFORMANCE: CURRENCIES VS USD

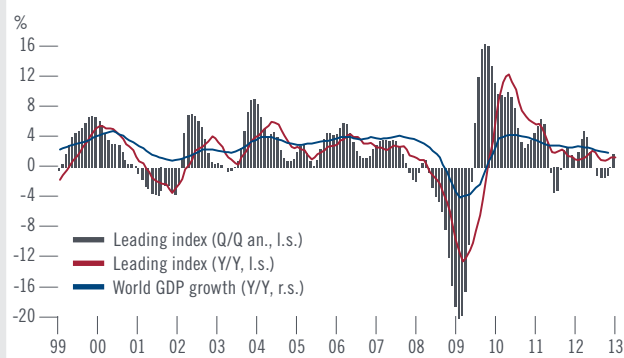


RISK BIAS INDICATORS: MONTHLY CHANGE

MONTHLY CHANGE Maximum change ◀◀◀◀ ▶▶▶▶		RISK-OFF —		NEUTRAL ○		RISK-ON +	
					Business cycle		
					Liquidity		
				Valuation			
	▶▶			Sentiment			
	▶			PAM strategy			

BUSINESS CYCLE: WORLD ECONOMIC ACTIVITY STILL IMPROVING

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

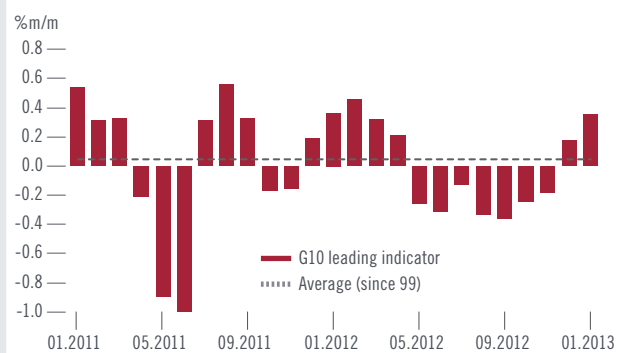


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

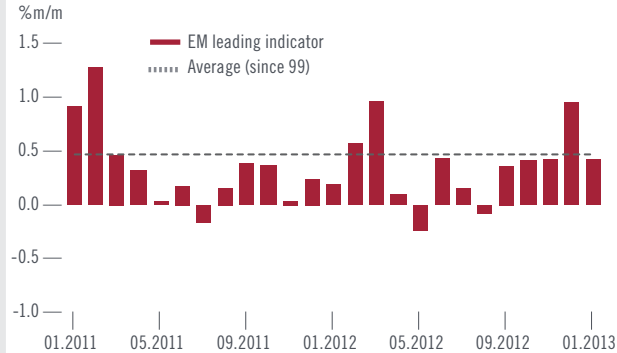


ECONOMIC MOMENTUM CONFIRMED IN G10 AND EMERGING COUNTRIES

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



VALUATION: EQUITY MARKETS AND SECTORS

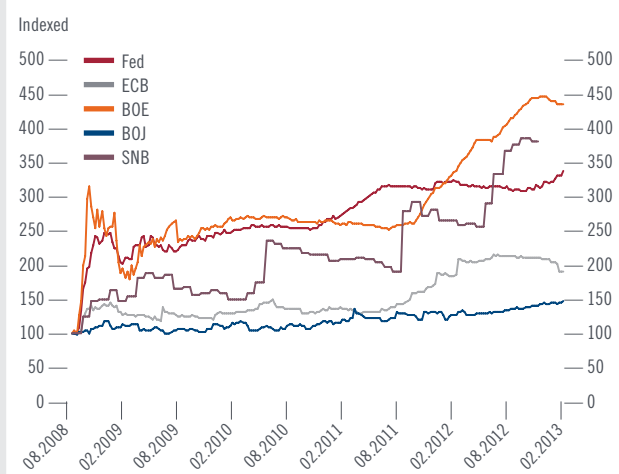
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
	2013	2014	2013	2014	2013	12M	2013E	2013E	2013E
US	7%	11%	2%	4%	13.5	13.2	2.0	1.4	2.3%
Europe	5%	12%	0%	5%	11.7	11.5	1.5	0.9	3.9%
EMU	5%	14%	-1%	6%	11.6	11.4	1.2	0.8	3.9%
Switzerland	9%	11%	5%	5%	14.7	14.5	2.3	2.0	3.2%
UK	6%	10%	0%	2%	11.5	11.3	1.7	1.1	4.0%
Japan	46%	13%	4%	3%	13.5	13.8	1.2	0.5	2.2%
EM	13%	11%	7%	9%	10.6	10.4	1.4	0.8	2.9%
NJA	13%	12%	6%	10%	11.7	11.5	1.5	0.8	2.6%
Global	10%	12%	2%	5%	12.7	12.5	1.6	1.1	2.9%

MSCI GLOBAL SECTORS	EPS GROWTH		SALES GROWTH		PE		PB	P/SALES	DY
	2013	2014	2013	2014	2013	12M	2013E	2013E	2013E
Energy	4%	9%	0%	3%	10.2	10.1	1.3	0.6	3.2%
Materials	18%	16%	6%	5%	12.5	12.0	1.5	0.9	2.7%
Industrials	12%	13%	5%	5%	13.6	13.3	2.0	0.7	2.6%
Consumer Discretionary	14%	15%	7%	6%	13.8	13.6	2.1	0.9	2.0%
Consumer Staples	9%	10%	10%	5%	16.7	16.3	3.2	1.0	3.0%
Health care	2%	9%	4%	5%	14.0	13.8	2.7	1.5	2.6%
Financials	10%	11%	5%	5%	11.3	11.1	1.1	1.5	3.3%
IT	11%	14%	7%	7%	12.8	12.4	2.4	1.5	1.8%
Telecoms	8%	9%	2%	3%	12.4	12.3	1.7	1.1	5.1%
Utilities	9%	12%	15%	3%	13.8	13.9	1.2	0.8	4.6%

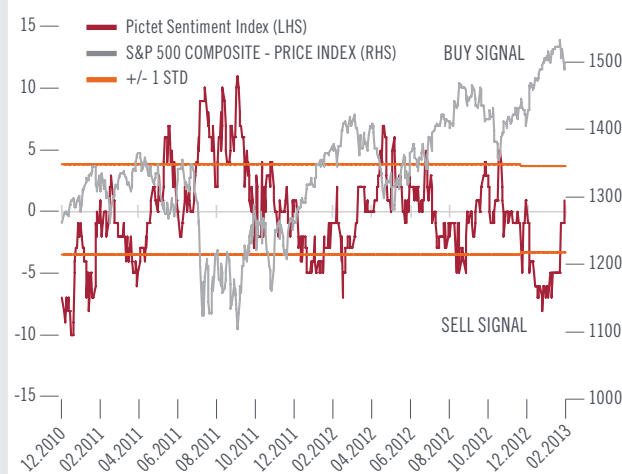
LIQUIDITY: STILL BOOSTED BY EASY MONETARY POLICY

SIZE OF CENTRAL BANKS' BALANCE SHEETS



SENTIMENT READING BACK TO NEUTRAL

PICTET SENTIMENT CYCLE INDEX



the fiscal contraction. Altogether, we estimate the US economy should still deliver growth of 2 per cent this year.

The economic picture is more muted in the euro zone, which remains in a mild recession. Although the region experienced a widespread slowdown in activity in the fourth quarter on weak domestic demand and slowing exports, our leading indicators have moved into positive territory for the first time since March of last year. The fortunes of countries at the core and the periphery continue to diverge: the German economy is picking up strongly while Spain's and Italy's are still deteriorating. Our expectation remains for a rate cut by the ECB in April – a move which would weaken the euro and provide a boost to the export sector, the region's current main driver of growth.

The lack of clear winners in the Italian elections has the potential to shatter the calm that had returned to European financial markets, following the ECB's promise to take all measures necessary to save the euro. In the absence of a strong government to force through a reform agenda, the fear is that Italy might be shut out of capital markets, and that jitters might spread to other heavily indebted economies.

In emerging markets, a continuation of positive readings of our leading indicators confirm a trough was reached in the second quarter of 2012 and the momentum

EUROPEAN BOND YIELDS DO NOT YET REFLECT THE REGION'S ECONOMIC STABILISATION



Source: Pictet Asset Management, Thomson Reuters Datastream

is still positive. Economic activity has recovered in China, supported by solid consumer spending. Construction activity is improving, although if price rises continue, the chance of further government action to cool the property market increases.

Our **liquidity** gauges continue to provide positive signals. Japanese Prime Minister Shinzo Abe has stated his intention to push for bolder measures to lift the country out of a 15-year deflationary spiral, and his choice of dovish monetary policy advocates for the Bank of Japan raises the odds of further central bank stimulus. The Fed Chairman has also reaffirmed the US central bank's commitment to its bond buying programme, calming fears of an early exit. Liquidity conditions are

less supportive in Europe, however, where we expect the central bank to cut rates in the next few months and an effective tightening of the balance sheet is underway, as confidence returns to financial markets and banks repay emergency loans.

Equity region and sector allocation

Time to take some profits in Japan

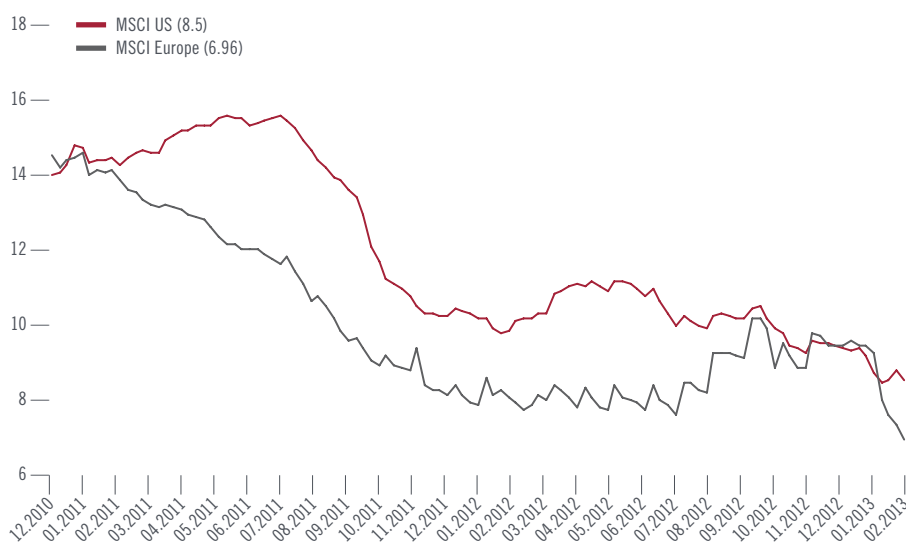
We maintain our overweight on Japan as valuations remain appealing, at 1.1 times price-to-book versus 1.8 times for global equities, and fiscal and monetary stimulus provide support. However, we feel the recent rally in Japanese stocks - nearly 36 per cent since November - offers an opportunity to take some profits, particularly since net earnings upgrades seem to have peaked and the yen has already corrected a lot.

By contrast, we remain cautious on European equities. The economic outlook is mixed and Italian instability could tie the ECB's hands, making intervention through the Outright Monetary Transactions programme (OMT) less likely. However, a few factors lead us to trim our underweight position. European indices have already experienced a correction, and the prospect of a possible cut in interest rates by the ECB over the next two months, which would support growth, is another positive. In addition, earnings growth expectations have been downgraded significantly over the past few months (see chart) and are nearing what we would consider reasonable levels.

We are still neutral on emerging markets but see value beginning to emerge. However, leading indicators have softened and earnings downgrades are still coming through. We believe it is too early for Chinese authorities to enact tightening

THE CYCLE OF EARNINGS DOWNGRADES IS COMING TO AN END

US and Europe 12m forward consensus earnings growth



Source: Pictet Asset Management

measures, but would like to see more confirmation that this is indeed the case.

Our global sector allocation is unchanged. We retain a preference for defensive sectors with good growth prospects such as consumer staples and pharmaceuticals, which have managed to outperform in a rising market this year. Our position in utilities is a contrarian long; the sector also scores well on valuation measures. A positive view on oil coupled with attractive valuations lead us to overweight energy stocks. Our largest underweights remain financials – where valuations are stretched and the sector looks overbought on our scorecard -

and telecoms, which continue to suffer earnings revisions and face significant economic and regulatory headwinds.

Fixed Income

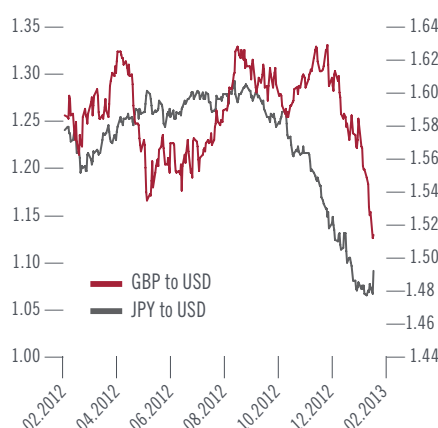
Stay long spread products

We still favour spread products over government debt as the search for yield continues in a low volatility environment, where aggressive deleveraging carries on. The normalization of government bond yields might have begun but it will be a long process. We upgrade European investment grade bonds to overweight on a tactical basis; our preference still goes to higher-yielding speculative grade and local currency EM debt.

Although the ECB still has not made use of its backstop, the OMT programme, there will be no magic bullet to solve the euro zone debt crisis. In the government bond space, we favour the 30-year part of the US curve; French government bonds are our biggest underweight. We took advantage of the sell-off in Italian bonds after the inconclusive elections to lock-in profits on our short position. We now expect the ECB to cut rates in April, with only a small probability of this happening in March - this would be a support but would not come as a surprise if growth, as we expect, remains very weak.

Our favourite asset classes remain high-yield debt, despite a rise of nearly 40 basis points in yields since mid-January, and EM bonds in local currency. The latter have decoupled from underperforming emerging equities and offer an attractive yield of 5.5 per cent. Emerging currencies, still relatively alluring as monetary policy

JPY AND GBP FALL SHARPLY AGAINST THE DOLLAR



Source: Thomson Reuters Datastream

remains ultra-loose in the developed world, could also be a strong source of returns.

Turning to currency positioning, we retain an underweight stance on both the euro and the Japanese yen. The Euro remains above its intrinsic (PPP) value and net speculative positions have turned positive, pointing to limited further gains. An ECB rate cut would also keep the single currency under pressure. The yen is already cheap on our models but we think that a more dovish BoJ stance and the G20's tacit support of government's refraction policy could push the currency to a level of 100 versus the US dollar. Sterling is also poised to weaken. Moody's recent downgrade of the UK's credit rating has sanctioned

an economy effectively in recession. Moreover, a relaxation of the inflation target, as suggested by the new central bank governor, could weaken a currency that already appears fairly valued on our proprietary model. We keep our overweight of the US dollar. The country is at a more advanced stage in the deleveraging process and downside risks to growth seem more limited than elsewhere in the developed world.

For more details, please read our recent flash note on Currency Wars published on 14 February.



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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)

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