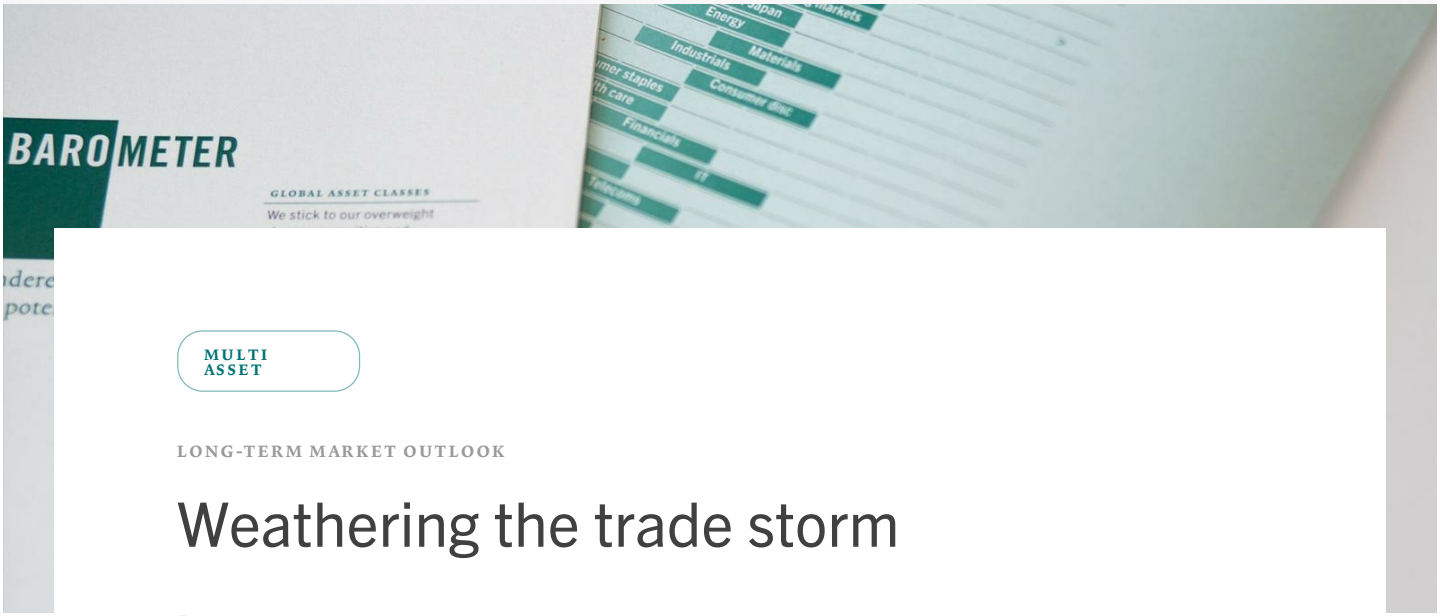
PICTET
Asset Management



MULTI ASSET

LONG-TERM MARKET OUTLOOK

Weathering the trade storm

Barometer

August 2018

Pictet Asset Management Strategy Unit

Despite escalating trade tensions, the global economy and corporate profits remain resilient.

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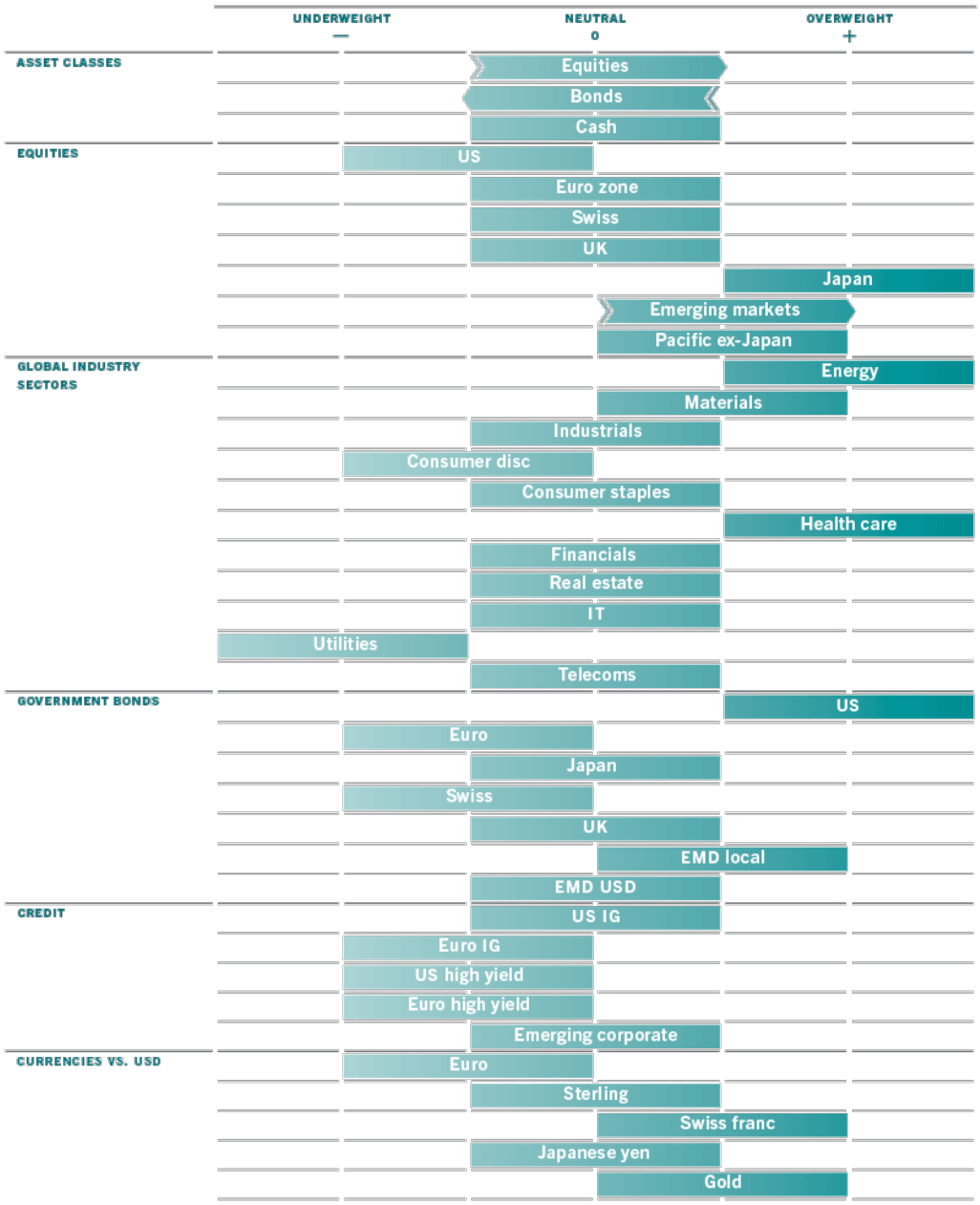
Asset allocation: turning less pessimistic

Trade wars are dominating the summer headlines, yet the global economy and markets remain surprisingly resilient. Corporate earnings are strong, particularly in the US, leading indicators have bottomed out, inflation seems to have peaked and China's fiscal and monetary authorities have once again started stimulating the economy.

This improvement in economic and financial conditions has, in turn, prompted us to rethink our overall stance on equities – we've lifted them to neutral from underweight and trimmed bonds to neutral from overweight.

MONTHLY ASSET ALLOCATION GRID
August 2018



Source: Pictet Asset Management

We decided against taking a more aggressive stance on equities for a number of reasons.

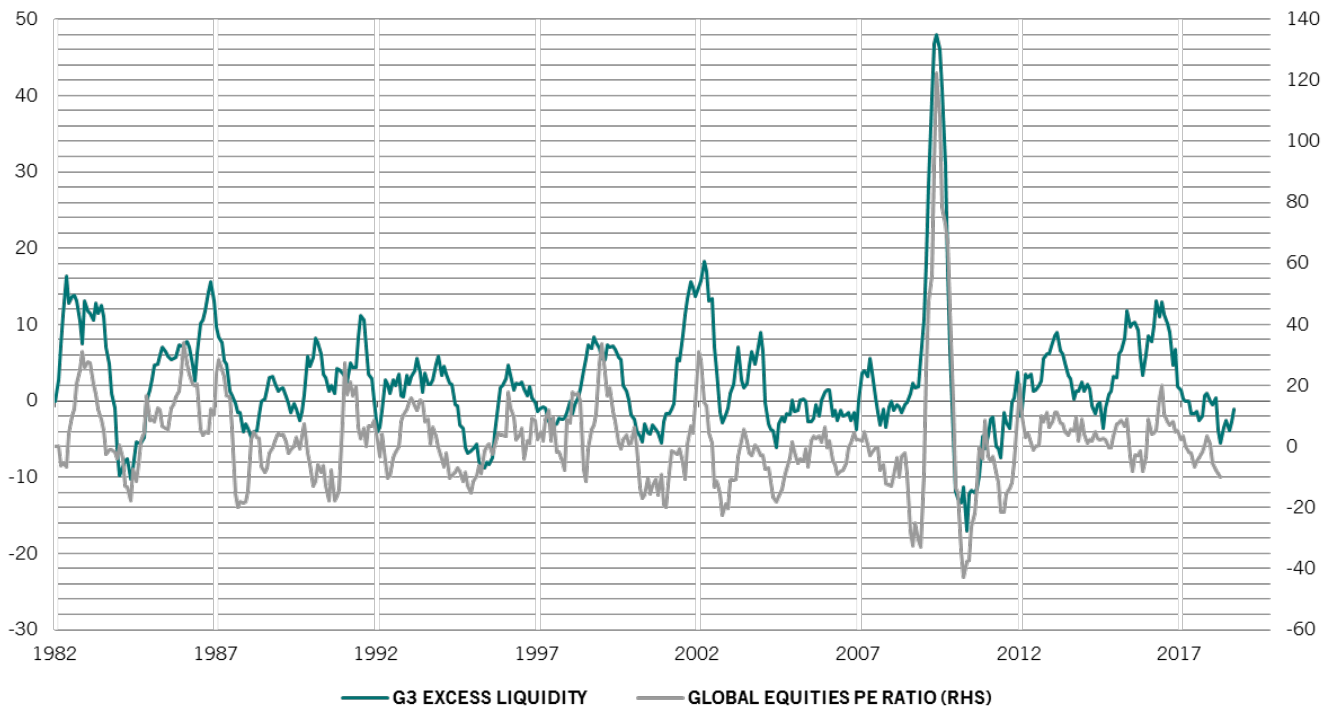
The first is trade. We remain concerned about longer-term prospects, however. Trade wars tend to be bad for growth and we think that if US President Donald Trump presses on with punishing tariffs, particularly against Chinese and European exporters, there are bound to be negative economic repercussions. US levies are expected to affect between USD500 billion and USD700 billion worth of trade, though some estimates figure the total could rise as high as USD900 billion.

Second, the US Federal Reserve shows no sign of being derailed from its aim of reversing monetary stimulus. The two policies could yet produce, if not a perfect storm, then certainly an unpleasant one for the world economy.

Still, our **business cycle** indicators suggest that for now the global economy's recent deceleration might have run its course. Emerging markets leading indicators have, on the whole, improved. These were led by a significant rebound in China, where the easing of both fiscal and monetary conditions, as well as a recent dramatic devaluation of the yuan are supporting growth. There is, however, a risk that the pick-up in Chinese manufacturing activity could be short-lived, having been driven by production brought forward before US tariffs start to bite.

Developed economies are still running at below trend growth. But they have shown some improvement (except for the euro zone which has deteriorated during the past month).

LIQUID TRENDS
Excess G3 liquidity and global equity PE ratios, 6m % change



Excess liquidity = G3 broad money minus value of domestic industrial production (volume*producer price index) growth over the past six months. Global Equities = MSCI World. Source Datastream. Data as of 02.08.2018

One of the key factors behind our more optimistic tilt on equities this month was an improvement in two key components of our **liquidity** model. In the US, private liquidity growth, possibly driven by corporate repatriation of money held abroad, is offsetting Fed tightening. We observe that the growth of private liquidity, particularly bank credit, is in fact broad based across regions. Meanwhile, in China, the one region where private liquidity isn't growing, the central bank has been easing policy.

A less negative stance on equities is also supported by our **valuation** metrics. Not only has the second quarter produced the best results season ever for US corporates, but other markets are also starting to catch up – the positive earnings story is filtering through to the rest of the world.

Technicals offer no clear trends, with few offsets from sentiment indicators. There, recent flows suggest the rout in emerging debt and equity is coming to an end. On balance, though, technicals are neutral for equities with negative seasonal effects in play through the summer months.

02

Equity regions and sectors: emerging bargains

Equity markets may not be cheap, but there are some bargains that are beginning to emerge.

Take emerging market equities. The asset class has been under pressure for a number of months as a stronger dollar, higher US interest rates and escalating trade tensions have cast a cloud over earnings prospects. However, there are signs that the worst may be over.

To begin with, developing economies have been resilient. Their real GDP is growing about 2.8 percentage points faster than that of developed economies on a 12-month moving average basis.

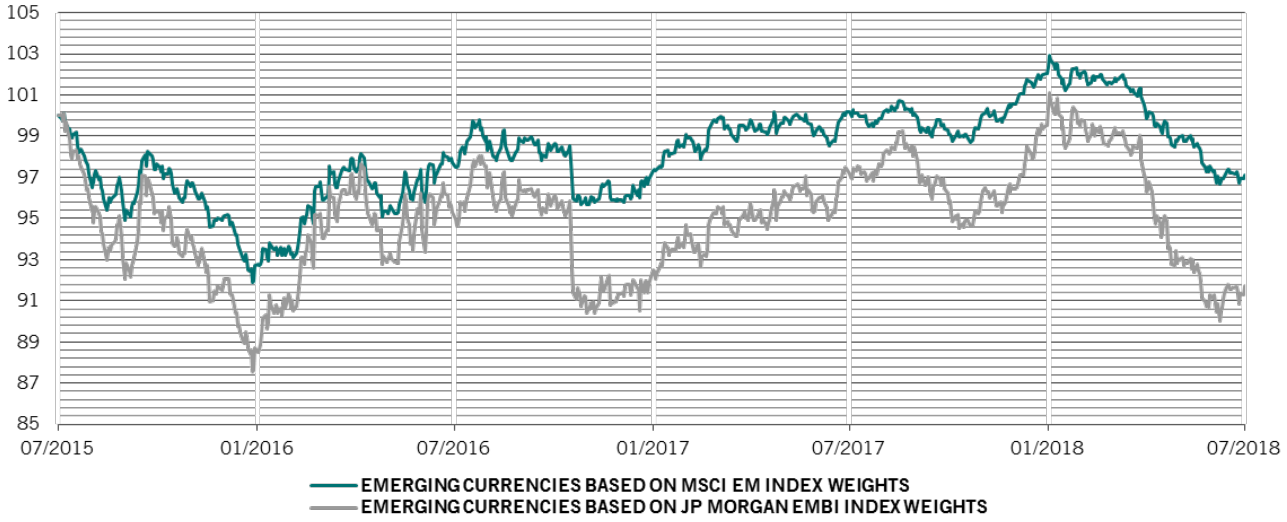
China is a particularly bright spot, where stronger consumption and construction activity lifted our leading indicator for four months in a row to the highest level since November. China's monetary policy easing is improving liquidity conditions, and authorities have also announced plans for fiscal stimulus. A recent decline in energy and commodity prices should offer additional support to the developing world's manufacturing economies.

Also, much of the bad news may already be factored into valuations after a heavy sell-off, which saw as much as USD9 billion leaving emerging equity funds since April, according to the Institute of International Finance.

Our calculations show that emerging equities now trade at a discount of more than 20 per cent to developed market counterparts, compared with the five-year average discount of 12 per cent. These are the sort of valuations that could encourage bargain hunters. Emerging companies are also in healthy shape, with their earnings expected to grow more than 13 per cent next year, above their five-year average.

What is more, the dollar's appreciation, which has unnerved investors because it has the potential to increase emerging markets' debt servicing and import costs, could also run its course. According to our calculations, emerging currencies are now undervalued by as much as 20 per cent against the dollar. We expect EM currencies to stabilise in the medium term, especially as their valuation is the most attractive in the currency market.

Given all this, we've upgraded our stance on emerging equities to positive from neutral.



July 2015 = 100. Source: Thomson Reuters Datastream, data covering period 24.07.2015 – 24.07.2018

Elsewhere, we keep our underweight stance on US stocks. It is the most expensive region in the world, and US companies look unlikely to repeat their blockbuster earnings performance of recent months.

Our models suggest that consensus earnings growth forecasts for next year of 10 per cent per share are excessive – they would require the US economy to deliver nominal GDP growth of at least 6 per cent, which is highly unlikely.

We're cautious on European equities given the possible impact on growth from US trade measures, especially on export-dependent Germany.

We stick to our neutral stance on technology stocks. The tech industry has seen mixed fortunes of late as some companies have struggled to beat high investor expectations for their earnings, leading to a sharp decline in their share prices. Our overweight stance remains unchanged on healthcare, a defensive sector that is largely insulated from trade tensions.

In contrast, we are cautious on economically-sensitive sectors, such as industrials, financials and consumer discretionary. Despite the recent rerating, global cyclical stocks are still trading at 24 per cent premium relative to their defensive counterparts, near a record high and well above a long-term average of 10 per cent.

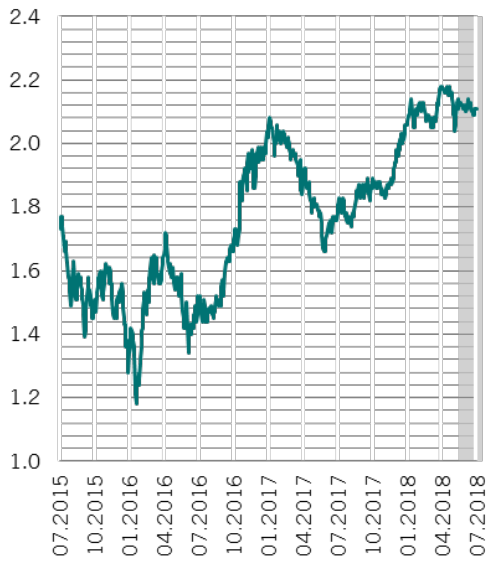
03

Fixed income and currencies: cheap Treasuries

When it comes to temperatures, things are clearly heating up for the summer across the northern hemisphere. But, when it comes to inflation, it seems the reverse is true. Notably, that's the case even in the US, where rising price pressures have been a key concern until now.

On a three-month annualised basis, core US consumer price index (CPI) inflation has eased down to 1.7 per cent in June from a 10-year peak of 3.1 in February, reflecting a stronger dollar as well as more fundamental factors.

MARKET'S INFLATION EXPECTATIONS STABILISE
US 10-year breakeven inflation, %



Source: Thomson Reuters Datastream, data covering period 24.07.2015 – 24.07.2018.

Meanwhile, market implied inflation, as shown by 10-year breakeven rates – the difference between the yields on inflation protected securities and those on ordinary government bonds – have stabilised at around 2.1 per cent (see chart). A peak in inflation would have a couple of consequences. First, it may give the Fed more reason to pause, and second, it may cause a downward repricing of the inflation premium – making assets which are seen as an inflation hedge less expensive relative to other investments.

In fixed income markets, such developments would be good news for Treasuries. Which is why we retain a strong overweight in the asset class – a position which is also supported by our liquidity and valuation models.

In terms of valuations, meanwhile, Treasuries are the cheapest of all their major developed market peers. They offer particularly compelling value when compared to Europe, where we remain underweight: 10-year real yields on German Bunds are holding at a negative 0.9 per cent.

Also offering good value in fixed income is emerging market government debt. That is all the more notable given an improvement in the fundamentals of developing economies: Chinese economic growth is picking up, for example, while the political backdrop in both Brazil and Mexico looks more stable than it did a few months ago. Furthermore, emerging currencies are around 20 per cent undervalued versus the dollar, according to our models, while average inflation in developing countries is at historic lows.

Trade tensions with the US remain a risk, but we think the backdrop is positive enough and risk premia elevated enough to justify a modest overweight on EM local currency debt. Europe's corporate bonds, by contrast, look expensive, which is particularly worrying as credit ratings have fallen.

Separately, when it comes to currencies, we think any dollar strength will likely be most pronounced against the euro.

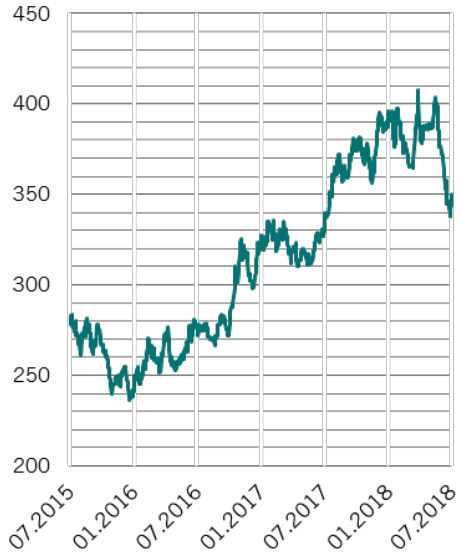
04

Global markets: weak commodities, strong stocks

Equities led the pack in July, returning over 3 per cent in local currency terms. Gains were broad-based, with all the major regions and sectors finishing the month in positive territory.

Tech stocks added 1.7 per cent on the month, maintaining their position as the best performing sector for the year so far. The gains came even though Facebook lost a record USD120 billion off its market capitalisation in one day on news of slower use and sales growth, while Netflix shares fell after it missed analyst forecasts on subscribers. However, Google's parent Alphabet, Amazon and Microsoft and Apple all delivered upbeat reports, helping to prop up the broader sector.

METALS UNDER PRESSURE
S&P GSCI Industrial Metals spot price index



Thomson Reuters Datastream. Data covering period 24.07.2015 - 24.07.2018

Energy and materials stocks managed to gain around 2-2.5 per cent despite significant sell offs in both oil and commodities, including industrial metals (see chart). This likely reflects the fact that equity markets have been lagging the strong rallies seen in the raw material prices earlier in the year. Indeed, despite July's performance, oil remains by far the best performing asset class for the 2018-to-date, with commodities in second place.

In the US, the second quarter results season kicked off well, boosting share prices. By July 27, half of the S&P 500 companies had reported, with earnings at 82 per cent of them beating analyst expectations, according to Thomson Reuters data.

Latin American shares gained more than 6 per cent. Sentiment on Mexico was lifted by the renewal of talks to renegotiate the North American Free Trade Agreement (NAFTA), as well as by the moderate political tone adapted by newly-elected president, Andres Manuel Lopez Obrador. In Brazil, too, markets welcomed signs of increased political stability after business-friendly presidential candidate Geraldo Alckmin secured the backing of a centrist coalition. In both cases, investor optimism wasn't just limited to equities – the Mexican peso and Brazilian real both gained significant ground versus the US dollar.

The UK, meanwhile, lagged most other developed market countries with stock market gains of just around 1.5 per cent and a weaker sterling, as investors fretted about the increased likelihood of an economically unfavourable outcome from the Brexit negotiations.

05

In brief

BAROMETER AUGUST 2018

Asset allocation

We lift equities to neutral and cut bonds to neutral.

Equity regions and sectors

We upgrade emerging equities to overweight, keeping an underweight stance in the US.

Fixed income and currencies

We continue to favour US Treasuries and emerging market local currency debt.

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