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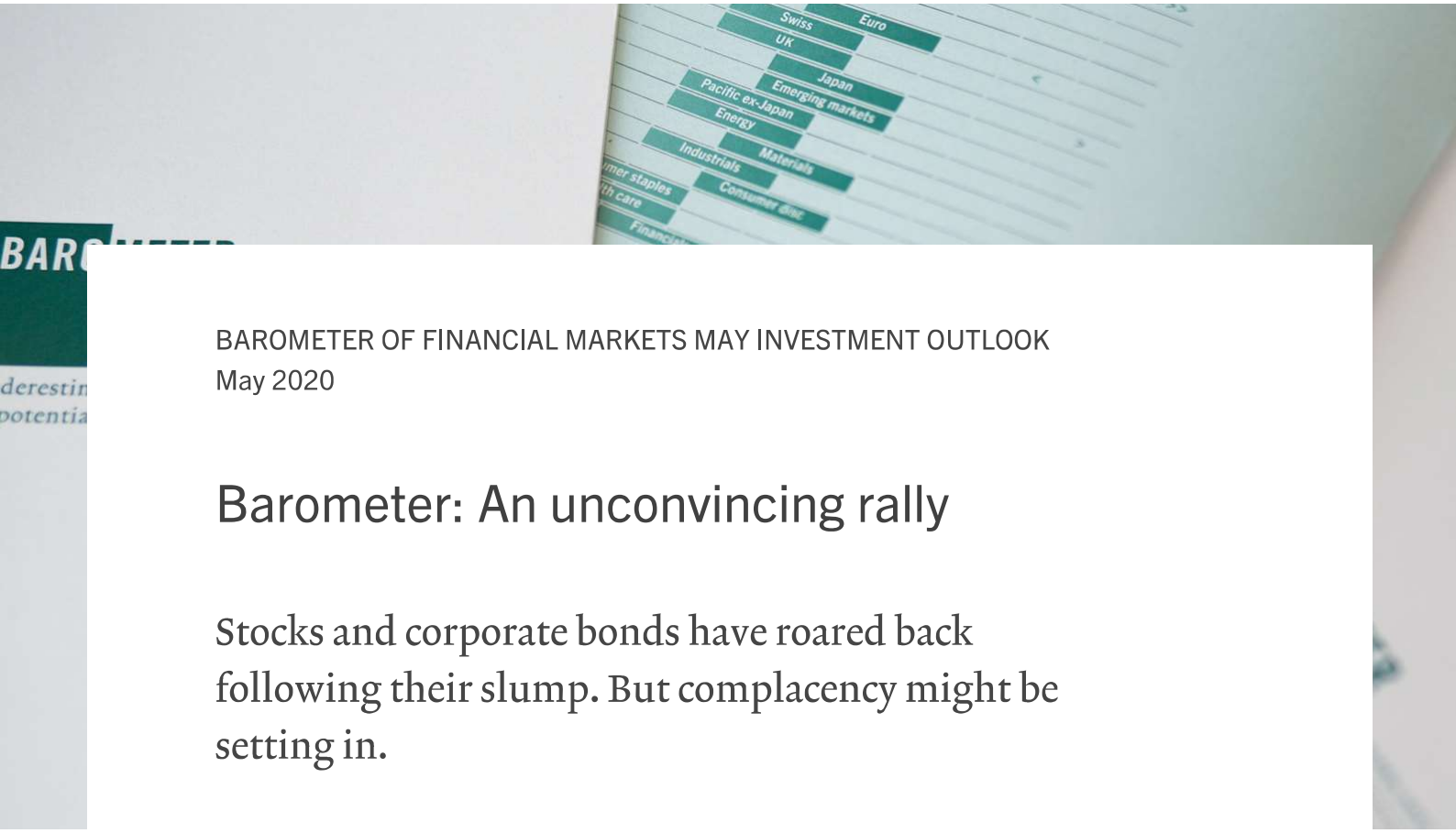

BAROMETER OF FINANCIAL MARKETS MAY INVESTMENT OUTLOOK
May 2020

Barometer: An unconvincing rally

Stocks and corporate bonds have roared back following their slump. But complacency might be setting in.

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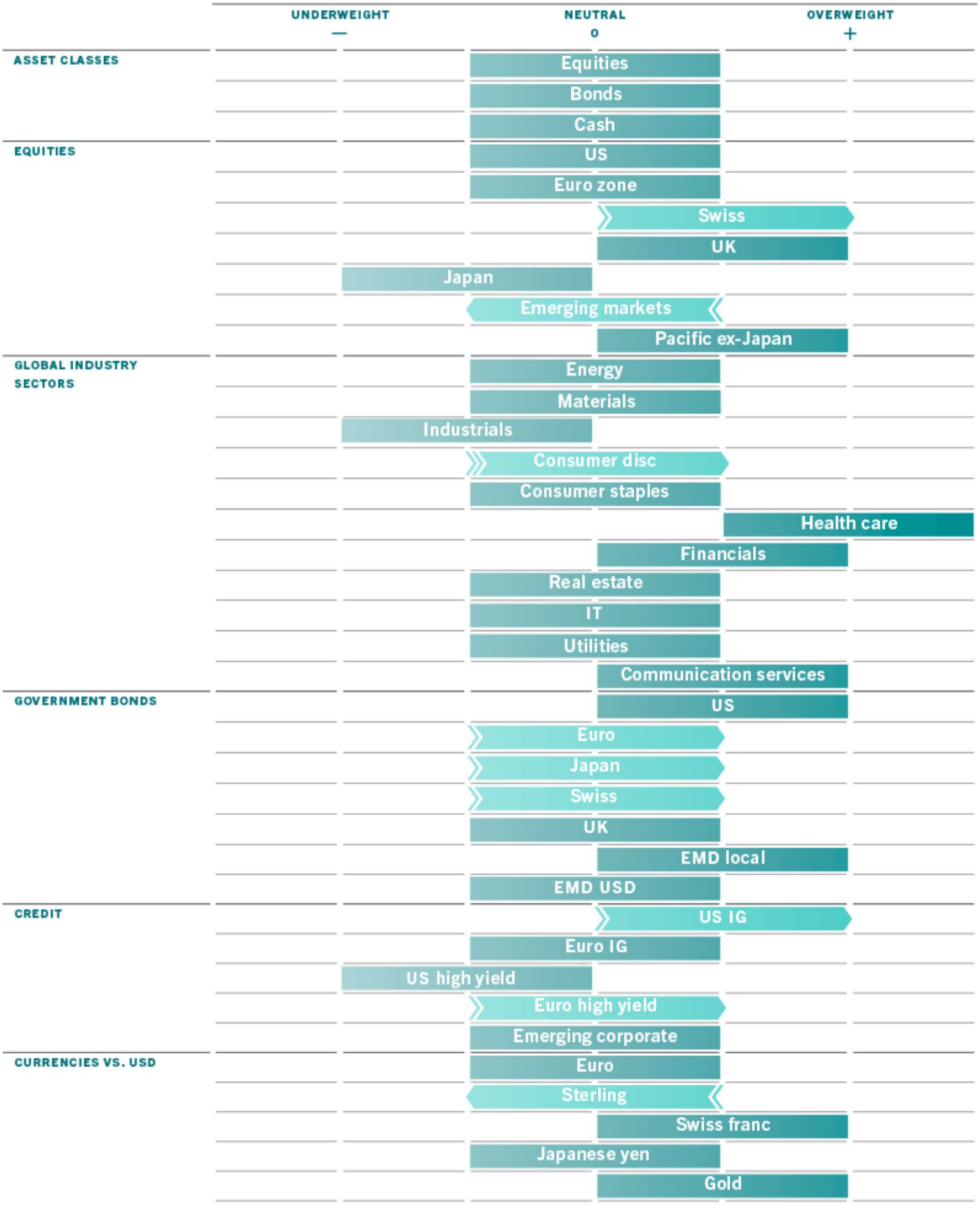
Asset allocation: complacency setting in

With the number of new coronavirus cases seemingly peaking, and some countries in Asia and the euro zone emerging from their lockdowns, economic conditions are stabilising a little. Stimulus - delivered in generous amounts and at speed - has played a major role in stocks' recent recovery.

Even so, there is bound to be more turbulence ahead - not least the possibility of further waves of the virus.

We therefore retain a neutral stance on equities, bonds and cash, and have shifted allocations among regional equity markets and fixed income assets to reflect the risks and opportunities emerging over the coming months.

Fig. 1 Monthly asset allocation grid
May 2020



Source: Pictet Asset Management

Our **business cycle** analysis shows the global economy will contract by 3.3 per cent this year, before recovering to grow by nearly 6 per cent in

2021. To limit the contraction, governments and central banks the world over have delivered stimulus on an unprecedented scale. We estimate the global fiscal impulse to be worth around 3.9 per cent of GDP – slightly more than double the 2009 response.

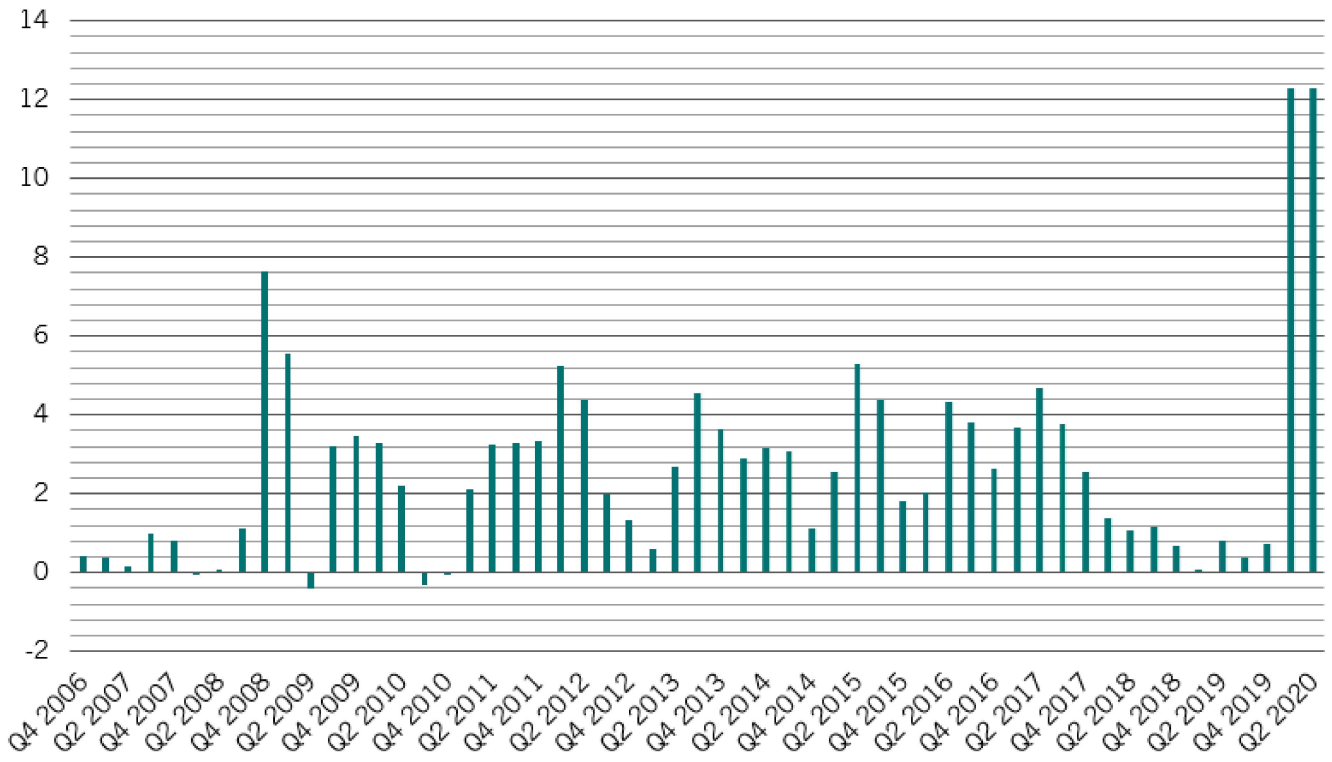
There are some early signs the stimulus is starting to work; we are now taking a slightly more constructive (or at least less pessimistic) view on the short-term economic prospects for the US, Australia, Switzerland, China and the rest of emerging Asia. We are also beginning to see value in consumer discretionary stocks.

However, in other parts of the world, the stimulus has so far been insufficient. Some areas, such as parts of Latin America, are hampered by their external trade balances and pre-existing problems. Others, like the euro zone, have the scope to do much more when it comes to stimulus measures.

Encouragingly, we are now seeing more from China, which had up until now been a clear laggard in stimulus provision. China's credit impulse,[1] a broad measure of credit and liquidity to the real economy, surged to a decade-high above 9 per cent in March.

Globally, our **liquidity indicators** point upwards, with the biggest single boost coming from the US. The US Federal Reserve has already delivered approximately 500 basis points of easing – through a mixture of interest rate cuts and balance sheet actions – and we see the scope for much more by year end. That would be more than the cumulative easing undertaken over the previous seven-year economic cycle which included the global financial crisis.

Fig.2 - A monetary boost
G5 central banks' liquidity injections, % GDP



Central bank liquidity flow calculated as central bank net liquidity injection over preceding 6 months, as % of nominal GDP, using current-USD GDP weights. For 2020: our estimate for the entire year. Data covering period 01.10.2006-30.06.2020. Source: Pictet Asset Management, Refinitiv.

Across the board, **valuations** for mainststream asset classes less attractive than they were at the end of March. Developed government bonds in particular are looking very expensive. Our valuation model suggests that equities should outperform bonds by 10-15 per cent over the next 12 months.

This view is supported by our **sentiment indicators**, which marginally favour riskier asset classes. Investor positioning in equities is far from overstretched and record inflows into money market funds suggest there is plenty of cash to be deployed. Globally, net assets in money market funds have ballooned by USD1 trillion over the past month.

[1] Year-on-year change in total social financing quarterly flow (ex-equity)

02

Equities regions and sectors: defence the best option

It's been tumultuous several weeks for stock markets.

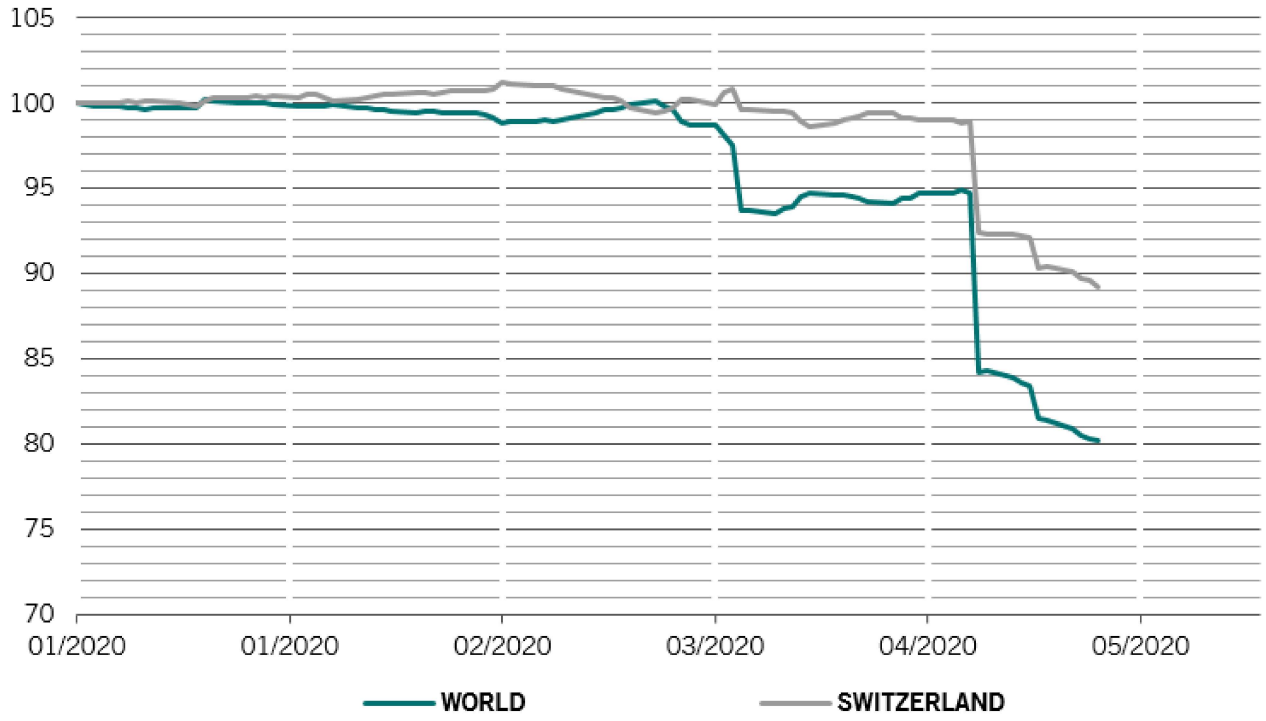
The S&P 500 fell over 30 per cent in little over a month only to storm back by more than 20 per cent since troughing on March 23. Now, much like many of its Asian and European counterparts, the US index is – technically at least – back in a bull market.

However, the dizzying rally doesn't leave us feeling particularly enthusiastic about stocks. We continue to be cautious on equities in the near term - markets seem to be overestimating the speed of economic recovery.

Globally, corporate earnings are expected to fall by less than 10 per cent this year, according to consensus forecasts, and stage a strong recovery next year. This is too optimistic.

Our models show that the EPS and dividends should fall by around 40 per cent this year. A concern is that while EPS fell by a similar magnitude during the 2008-2009 crisis, the recession then was 3-4 times milder than the slump the world is currently grappling with.

Fig. 3 - Switzerland's defensive tilt helps stocks outperform
12-month forward earnings per share for world and Swiss shares



Source: Refinitiv, data covering period 01.01.2020 – 30.04.2020

Within equities, we continue to favour defensive markets and sectors.

We've upgraded Swiss equities to overweight. Switzerland has the highest share of defensive stocks (by industry sector) of all major equity markets. Some 60 per cent of the Swiss benchmark index's market capitalisation derives from defensive sectors - pharmaceuticals and consumer staples companies, the majority of which have outperformed during the coronavirus crisis.

We also like stocks in the UK, which is home to a number of large-cap defensive companies trading at attractive valuations.

We remain neutral on US equities, which have become one of the most expensive markets in the world after the 12-month forward P/E ratio hit a 18-year high of 19 times from just 13 a month ago.

Investors are banking on a speedy recovery for US corporations, but we see the prospect of more analyst earnings downgrades in the coming

months.

We have also become cautious on emerging equities, which we downgrade to neutral.

While economic activity in China and its immediate neighbours is gradually getting back to normal, Latin America is in the midst of the virus crisis. The region, heavily reliant on commodity exports, was already under severe economic strain before the virus outbreak.

What is more, countries such as Brazil have limited means to counter the economic shock because of external deficits and chronic inflation.

Elsewhere, we have turned neutral on consumer discretionary stocks - which we upgrade from underweight - as consumers in Asia and other major economies may loosen their purse strings after weeks of lockdown, albeit gradually.

03

Fixed income and currencies: central banks build a floor

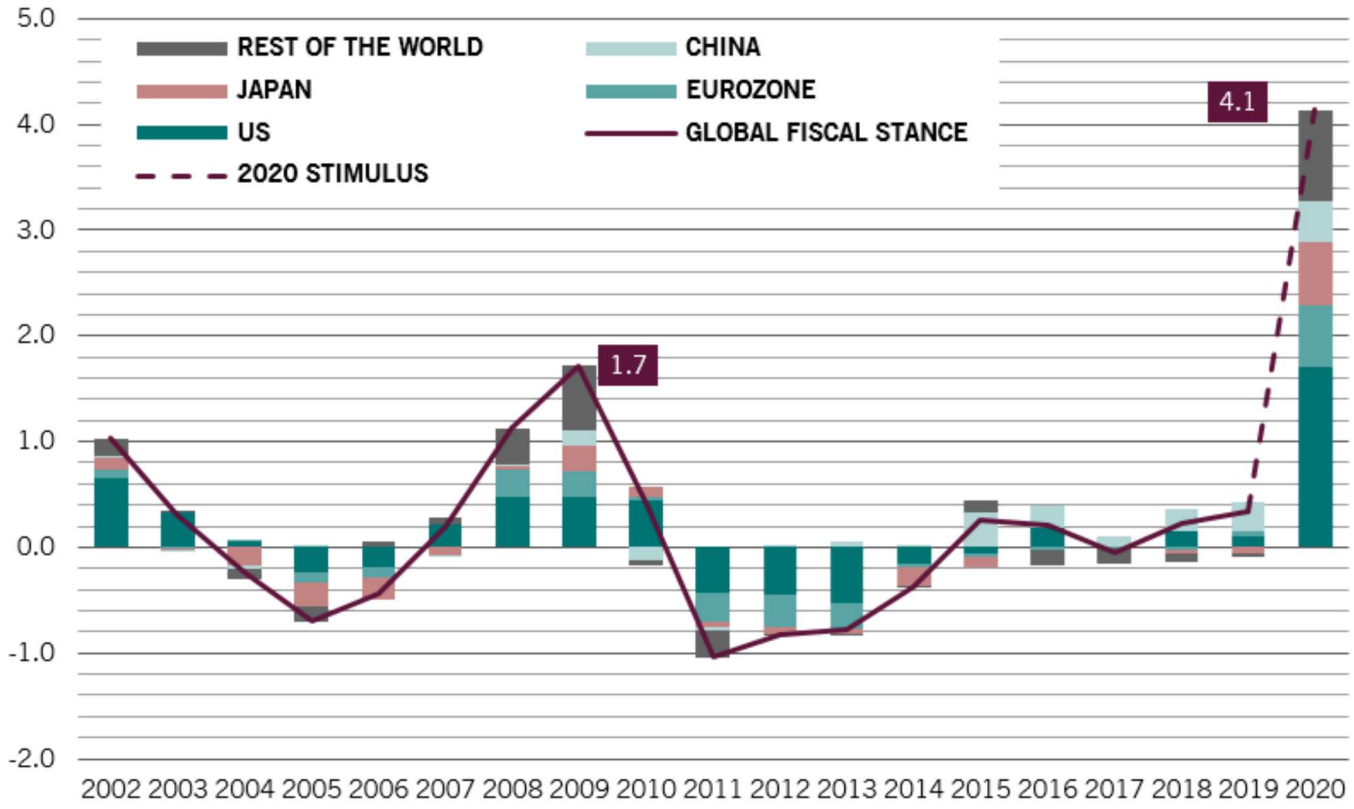
Massive amounts of central bank asset purchases aimed at containing the economic consequences of the coronavirus pandemic is offering cast-iron support for developed market sovereign and corporate bonds.

As a result, we upgrade European, Swiss, UK and Japanese government bonds to neutral from underweight and upgrade US investment grade credit to overweight from neutral and European high yield credit to neutral from negative.

Central banks have pumped an unprecedented amount of stimulus into the financial system. The Fed alone has eased policy by the equivalent of 500 basis points since 2019 – of which a little under half has come in the form of actual rate cuts and the rest in asset purchases. And the US central bank is poised to provide more if necessary. Our models show that the Fed's total stimulus could amount to the equivalent of 900 basis

points reduction in rates, which is more than the cumulative easing undertaken in the seven years to 2014.

Fig. 4 - Stimulus abounds
Fiscal impulse (% of potential GDP)



Data covering period 01.01.2002-30.02.2020. Source: Pictet Asset Management, CEIC, Refinitv

Other central banks may have had less room for manoeuvre, but the stimulus has come from all sides.

For its part, the ECB will be absorbing some 90 per cent of net new issuance by the single currency region's governments this year.

And while the Chinese central bank has been less obviously aggressive, stimulus there has come in the form of massive credit expansion, the biggest since the global financial crisis, and worth 9 per cent of domestic GDP.

Central banks have also launched aggressive measures to protect the corporate credit markets.

For instance, the Fed is covering some 70 per cent of the US investment grade market's borrowing needs this year, while both it and the ECB have ventured into supporting parts of the high yield market – which hitherto has been taboo.

Among currencies, we feel that sterling has seen the best of its rebound for now, so we reduce our stance on it to neutral from overweight. The UK economy remains at risk not just of a slow reopening – cases and deaths from the pandemic remain high – but Brexit continues to cast a cloud.

We remain overweight gold. While massive fiscal packages around the world may lead to higher inflation at some stage, we think investors will be more concerned about near-term deflationary forces as they wait to see the extent of damage from economic paralysis. This is an investment climate that supports save-haven assets like the precious metal.

04

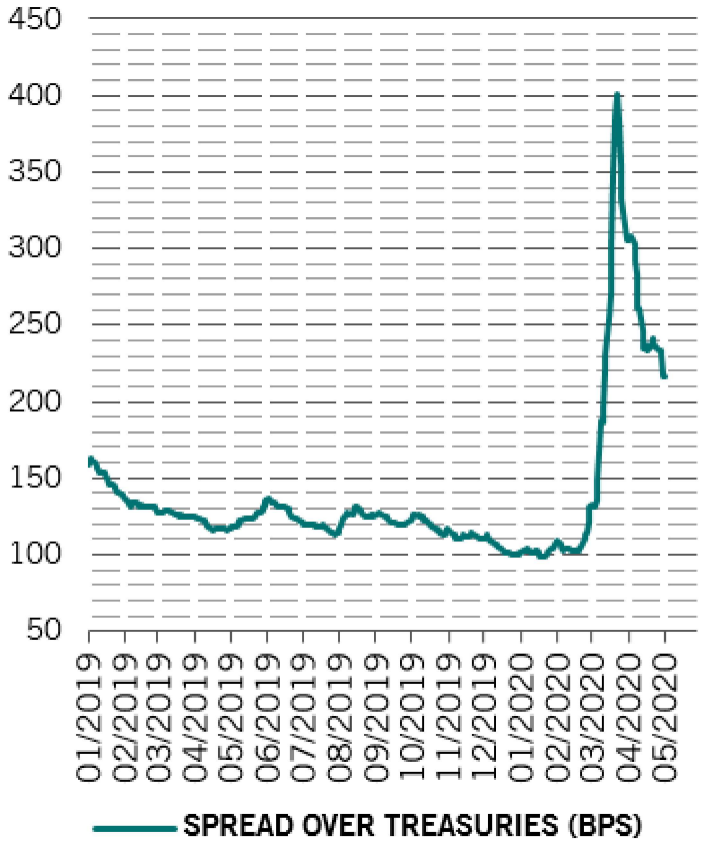
Global markets overview: slump and rally

Global stocks ended April with a solid 10 per cent gain after volatile few weeks that saw major indices suffer a brutal bear market. Investor spirits were lifted by signs of an easing of the pandemic, progress in the race to find a vaccine and continued monetary and fiscal stimulus.

Wall Street delivered among the biggest gains in developed markets, thanks in part to the resilience of big technology giants, which account for more than 15 per cent of the benchmark S&P 500 index.[1]

Stock markets in emerging Asia, also home to major tech companies such as Tencent, Alibaba and Samsung, rose more than 7 per cent in local currency terms. Investors have become increasingly confident over the prospect of economic recovery in the region as China gradually restarts its engines after weeks of lockdown.

Fig. 5 Narrowing the gap
Spread of ICE BofA US Corporate Index over Treasuries in basis points



Source: Refinitiv, data covering period 01.01.2019 – 30.04.2020

Energy and consumer discretionary stocks recovered particularly strongly from an earlier rout as investors were attracted to their favourable valuations. The rise in energy stocks was all the more remarkable as oil prices slumped in the midst of a severe supply glut. (The price WTI crude for May delivery spiralled into negative territory)

Bonds underperformed equities, ending the month flat by and large. UK gilts rose the most among major sovereign debt markets.

In credit, European high-yield debt rose by more than 5 per cent, reducing this year's loss to around 10 per cent. US investment grade and high yield bonds also ended the month higher, thanks to the Fed's beefed up asset purchases programme.

The dollar was flat on the month, but it failed to stop energy and commodity prices from falling further. Oil fell 8 per cent in the month, bringing this year's losses to 64 per cent. Gold continued to bask in the safe-haven glow as it rose nearly 6 per cent.

[1] Apple, Microsoft, Alphabet, Amazon and Facebook

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differ materially from those presented herein.

05

In brief

BAROMETER MAY 2020

Asset allocation

We retain an overall neutral stance on equities, bonds and cash.

Equities regions and sectors

We continue to favour defensive sectors and markets, while we're turning more cautious on emerging stocks outside of Asia.

Fixed income and currencies

We are neutral on all government bonds except US Treasuries, which we are overweight. We upgrade US investment grade credit to overweight and European high yield credit to neutral.

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