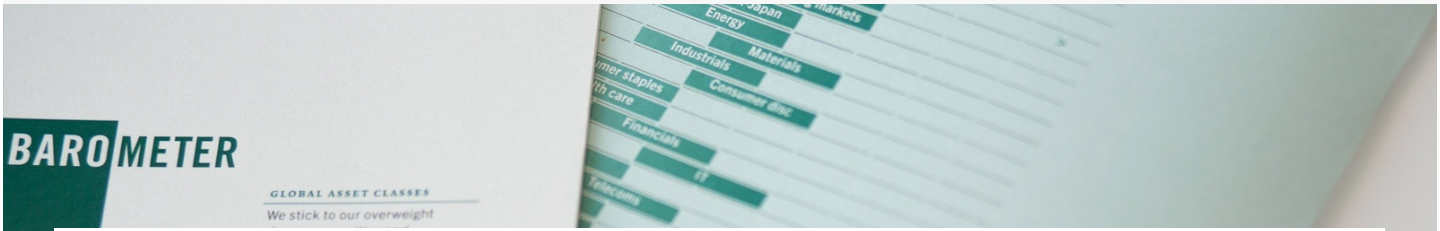
PICTET
Asset Management



MULTI ASSET

MONTHLY ASSET ALLOCATION VIEWS

From rout to recovery

Barometer

November 2018

Pictet Asset Management Strategy Unit

Almost all assets were battered by October storms as investors worried about rising rates and trade wars. But that has opened up some tactical opportunities.

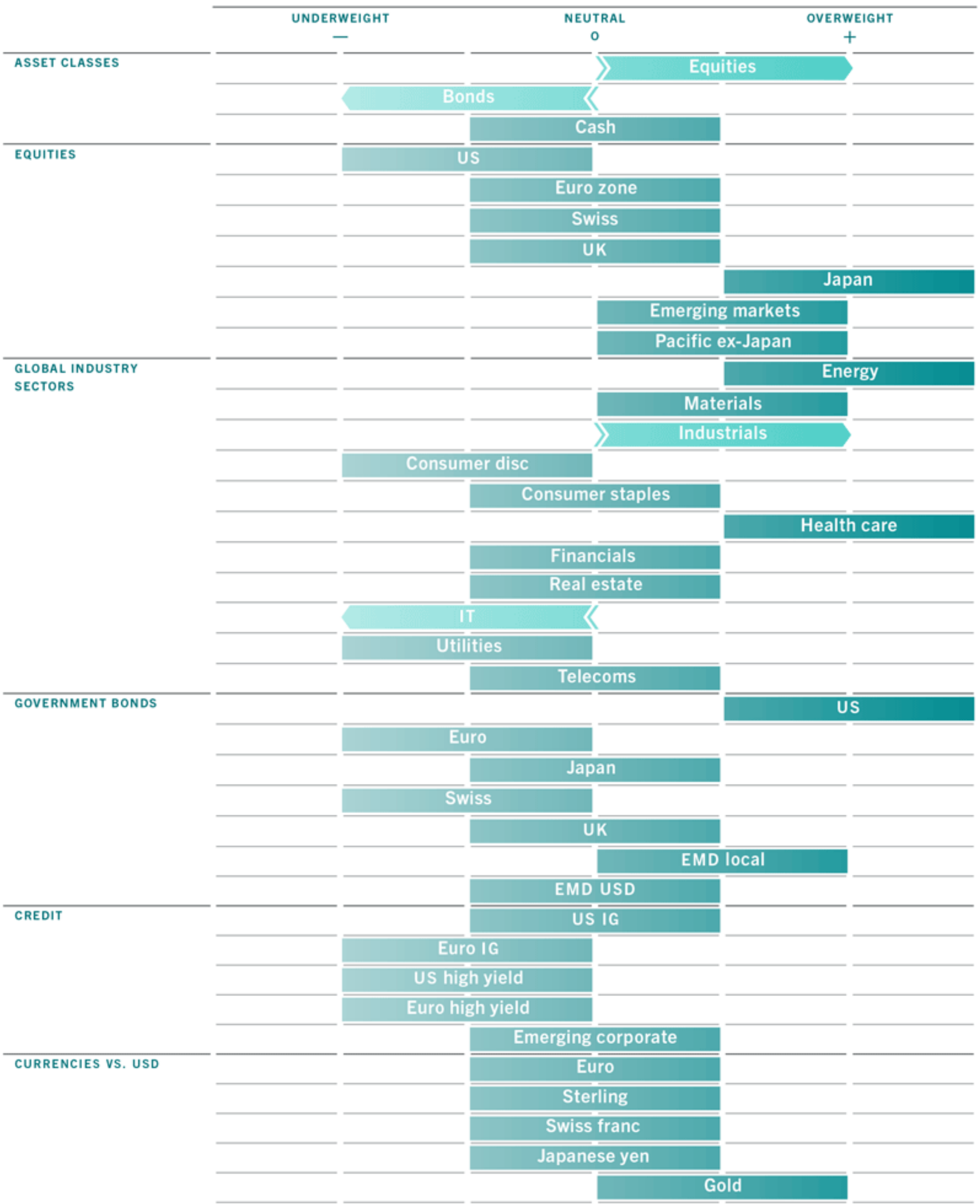
Table of contents

01

Asset allocation: equities to recover after October rout

October proved a cruel month for equities, with virtually all sectors and regions mired in red. Yet we believe there is plenty of scope for stocks to stage a recovery, which is why we have raised our allocation to equities to overweight from neutral and downgraded bonds to underweight.

MONTHLY ASSET ALLOCATION GRID
November 2018



Source: Pictet Asset Management

It is true that the bull market which stocks have experienced for much of the last decade had gone too far, but so too has October's sharp correction.

After sinking by some 10 per cent in four weeks, global equities are now inexpensive: according to our models, **valuations** for world stocks are below their 20-year historical average for the first time in two years. The price-to-earnings ratio for the MSCI ACWI dropped to just 13.3 times by the end of October from 15.0 times a month earlier and 16.9 times in January. Regionally, Asia looks particularly cheap, as do most emerging markets (excluding Latin America).

Notably, the massive reversal in prices and valuations has not been accompanied by any major changes in either economic or corporate fundamentals. In fact, our **business cycle** indicators suggest both that the global economy remains on a firm footing. Globally, while corporate earnings growth peaked in the first half of 2018, it remains solid at an annual pace of some 15-20 per cent (see chart).

UNEARNED CORRECTION
Change in MSCI ACWI index versus 12-month EPS growth, 100 = 28.10.2015

Source: Bloomberg. Data covering period 28.10.2015-31.10.2018.

There are, of course, a number of risks on the horizon, including the US/China trade disputes and uncertainty over the outcome of US mid-term elections.

As far as tensions between the US and China are concerned, we think much of the negativity has already been discounted by markets, leaving the opportunity for surprise developments that would be taken positively by global equities. Such a surprise could take the form of new US-China trade deal potentially around the G20 meeting in Buenos Aires at the end of November.

The US elections present a different set of risks. The consensus view is that Democrats will win the House and Republicans will hold the Senate. We believe this scenario - legislative gridlock that would likely keep fiscal policy, regulation and trade policy constant - is more or less already reflected in asset prices. It's worth pointing out that all but two of the mid-term elections held since 1946 have ended with the President's party losing control of the House of Representatives.

If, however, the Republicans unexpectedly end up retaining control of both the Senate and the House, this could pave the way for more fiscal stimulus and a renewed deregulation drive, which – at least in the short term – could be good for the economy and for stocks. Conversely, it would likely fuel inflation and lead to a deterioration the deficit, encouraging the US Federal Reserve to up the pace of rate hikes.

That would add to an already fairly bearish backdrop for bonds as painted by our **liquidity** indicators. US liquidity conditions remain negative, and there are signs that the Fed's twin-pronged tightening policy – through interest rate hikes and the withdrawal of quantitative easing – is starting to bite. In contrast, China stands out as the only major central bank actively loosening policy, which supports our positive stance in emerging markets.

On a global basis, **technical** indicators support our tactical preference for equities over bonds this month. Short-term sentiment signals for equities are very positive as a result of heavily oversold conditions across almost all the regions. Seasonality – the tendency for equities to rally at the end of the calendar year – is another factor to consider. In the longer term, economic growth will eventually slow, inflationary pressures will bite, and earnings will turn lower. But for now we believe that the equities sell-off has prepared the ground for one more burst higher.

02

Equity sectors and regions: emerging market and cyclical stocks to shine

The storm that blasted through global assets during October left large parts of the equity market looking attractive, at least over the near term. A sharp repricing of stocks – the MSCI's world share index dropped 10 per cent in four weeks, its worst monthly fall since 2012 – has taken equity valuations to below their average of the past three decades for the first time in two years – a shift that is at odds with fundamentals.

Favourable seasonality – stocks have a habit of gaining strength into year-end – reinforces our view that market is due a rebound.

Cyclical and emerging market (EM) stocks are likely to benefit most from this short-term bounce. Although evidence is accumulating that global economic growth and corporate earnings have already rolled over from their peak earlier in the year history tells us it's even more damaging to sell out of the last, frothy stage of a bull cycle than it is to sell too late.

Some of the biggest losers during recent months were global cyclical stocks. They have underperformed the market by 12 per cent since their early June peak and are now the most oversold in seven years, which has opened up pockets of value.

INDUSTRIALLY CHEAP

Ratio of MSCI ACWI Industrials relative to MSCI ACWI, price indices

Source: Thomson Reuters Datastream. Data covering period 25.10.2011-30.10.2018.

As a result, we've maintained our preference for inexpensive cyclical markets, particularly emerging markets (EM) and Japan, which is undervalued by a record amount on our models. Asian emerging markets represent particularly good value after having been battered through much of the year by concerns about trade wars and a slowdown in China.

Any signs of a rapprochement between the US and China on tariffs - which may emerge at a G20 meeting in November - could spark a strong revival in EM stocks in particular.

Meanwhile, we have raised industrial stocks to overweight following the sector's recent selloff, which had taken valuations for such stocks to a six year low on a relative basis in spite of a still bright outlook for global capital spending. At the same time, we've downgraded information technology to underweight. Even after lurching lower, the sector remains the most expensive on our scorecard and growth stocks will continue to come under pressure if, as we expect, bond yields continue to rise.

We still like late-cycle cyclical sectors such as energy and mining, as well as health care. By contrast, rising inflation and interest rates should prove a headwind for consumer discretionary stocks – indeed, house builders and car makers are already starting to struggle.

03

Fixed income and currencies: emerging market punishment goes too far

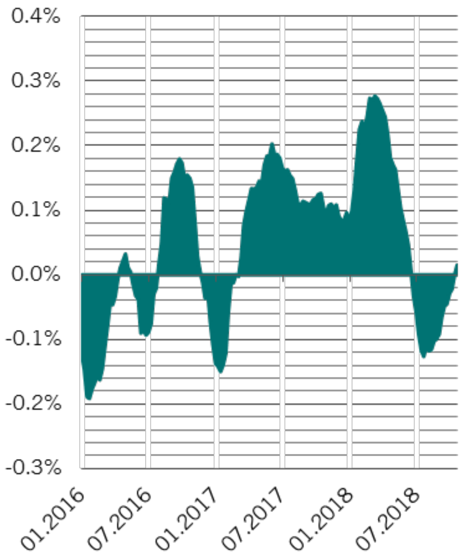
The stars are aligned for a recovery in local currency emerging market debt. Unlike past bouts of turbulence, this year's slump in EM bonds wasn't caused by a sharp downturn in the global economy, or a generalised equity market crash or even a commodity price collapse. Instead, it was a combination of slower-moving threats – the risks posed by an accumulation of EM corporate debt; the impact of the US strong dollar on countries and companies with dollar debt; the steady withdrawal of global monetary stimulus worldwide and US rate rises; the impact of US trade tariffs on China – that gave investors the urge to take profits on 2017's astonishingly good run.

To be sure, some of the market's re-evaluation of EM bonds and currencies was justified. Growth expectations for emerging economies have been revised down amid trade uncertainty. Their growth premium over developed economies is no longer widening. At the same time, they are having to adjust to the steady reversal of monetary stimulus by the Fed. But just as the market had rallied too hard in 2017, it has pulled back too much since. Economic prospects may look less rosy, but they're still positive.

By and large, EM economic fundamentals remain strong – government debt levels are generally low, balance of payments positions are healthy as are foreign currency reserves, while domestic demand remains robust.

EM policymakers have largely responded to the turmoil with well-calibrated policies. Interest rates were increased and reinforced with fiscal adjustments. Meanwhile, flexible exchange rates have helped to absorb the shocks. As a result, most EM economies have weathered the market storm largely unscathed. Indeed, the latest set of EM leading indicators have improved on a rolling quarterly basis, and currently stand well above their three-year moving average.

FLOWS TURNING POSITIVE FOR EM BONDS
Investment flows into EM local currency bonds, as % of net assets, 12WMA



Source: EPFR. Data covering period 06.01.2016-24.10.2018.

More broadly, the premium offered by EM debt now looks attractive. Emerging market currencies are the cheapest they've been relative to the dollar in at least two decades, according to our economists' valuation metrics. EM currencies are some 20 per cent undervalued against the dollar, with the renminbi cheaper than ever on a purchasing power parity basis. Meanwhile, EM local currency bonds yield more than 6.5 per cent compared to the 350 basis points or so offered by US high yield debt. Moreover, portfolio flows into EM assets have also been improving in recent weeks (see chart) – a trend which we expect to continue and offer further support to the asset class.

Elsewhere in fixed income, we find the prospects for developed market corporate bonds uninspiring, particularly among non-investment grade issuers. We are concerned about the impact US rate hikes might have on firms that borrowed heavily during the era of easy money. So far, markets have yet to discount the possibility of a credit crunch - both investment grade and high yield bond markets have proved rather resilient even though our analysis shows that outflows from funds holding such bonds have picked up sharply in recent weeks.

For more on the risks bubbling beneath the surface of the corporate bond market, please see our recent article, **Beware of fallen angels***.*

04

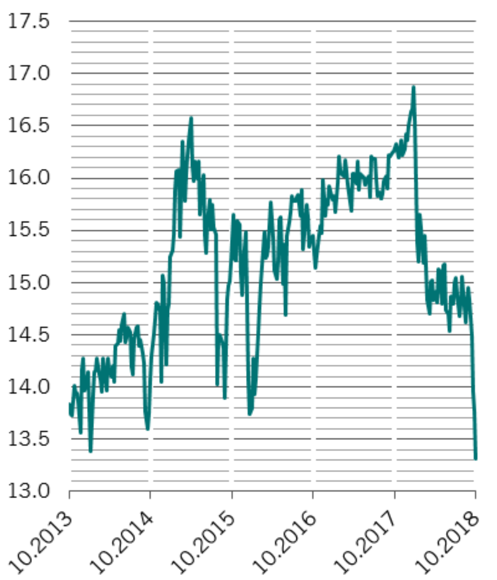
Global markets overview: horror show

The run-up to Halloween was a horror show for most markets and sectors as investors took fright at a combination of ever tightening US monetary policy and ever hotter global trade frictions. Investors were left with few hiding places –before the month-end rally, a mere 17 per cent of global asset classes was registering a positive return since the start of the year, a 30-year low. The slashing of valuations left trading screens (or should that be screams) awash in red. Global equities dropped more than 8 per cent in local currency terms, leaving the MSCI World Index down year to date. Bonds barely held level during the month and also registered a loss for the year of some 1 per cent.

Gold was one of the few assets that managed to sparkle during the month, up 2 per cent, though it remained down for the year. By contrast, even after oil's 8.7 per cent slump during the month, it remained up nearly 20 per cent on the year.

Asian equities were the most savagely brutalised, Japan and emerging market Asia both down on the month – 9 per cent and just under 8 per cent respectively. A heavy weighting towards cyclicals, not least tech (down 9 per cent), and concerns about the impact President Trump's trade war was likely to have on the region's economy precipitated the losses. Only Latin American equities managed to buck the trend, picking up a little more than 1 per cent on the month largely on the back of a Brazilian rally following its presidential election.

MSCI ACWI price-to-earnings ratio



Source: Thomson Reuters Datastream. Data covering period 29.10.2013-30.10.2018.

All equity sectors took a battering – with the exception of the previously unloved utilities which managed to stay broadly flat.

Unusually for a big equities correction, bonds failed to provide much of a hedge this month. Indeed, US and European bonds softened marginally. UK gilts were among the few positive performers, gaining on hopes for some positive resolution to Brexit. Corporate bonds were also broadly lower, albeit only modestly relative to the equity market's performance.

Among currencies, only the Brazilian real stood out amid a wider flight into the dollar. It surged 7.5 per cent on the month on hopes the new right-wing president-elect Jair Bolsonaro will prove to be market-friendly.

05

In Brief

BAROMETER NOVEMBER 2018

Asset allocation

We raise equities to overweight and downgrade bonds to underweight

Equity sectors and regions

We upgrade industrials following the market correction and downgrade IT, which continues to look richly valued

Fixed income and currencies

Emerging market local currency bonds are poised for a rebound