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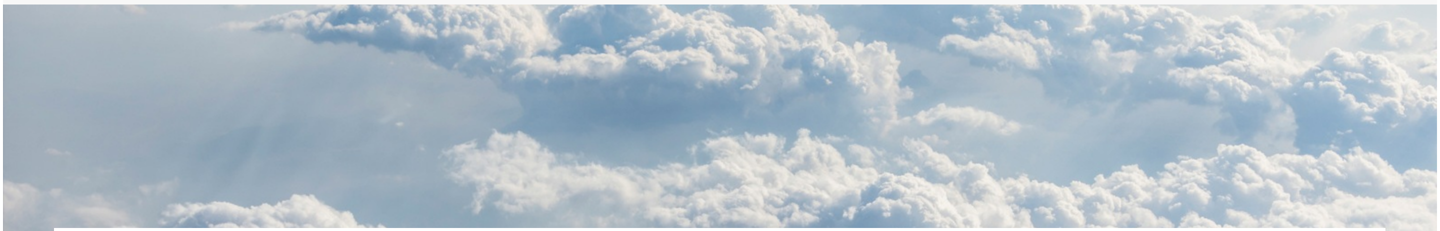
Asset Management



MULTI ASSET

ANNUAL OUTLOOK: ASSET ALLOCATION AND FINANCIAL MARKETS

The investment landscape in 2019

November 2018

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Investors should expect conditions to get tougher in 2019 as central banks are likely to continue tightening the monetary reins, leaving markets exposed to the risk of further political upheaval.

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Overview: risky business

If the stars were aligned for risk assets during most of the past decade, they look distinctly less bright for the coming year. An end to monetary stimulus across much of the world, the fading effects of the US's fiscal boost, trade wars, uncertainty over Italy and Brexit are all likely to play their part.

Slowing economic growth and a squeeze on corporate profit margins will take some of the shine off equities. And with wages at last growing and feeding through to inflation, bonds aren't likely to be much of a haven either: both investment and speculative-grade credit look particularly vulnerable to a correction. On the other hand, a weaker economy could be good for long-dated and index-linked US Treasuries and gold, while an overvalued US dollar could give back some ground. Under the circumstances, cash is set to be the best performing asset class.

PEAKY

US macroeconomic and market cycle indicator relative to long term history (percentile) [1]

Source: Thomson Reuters Datastream, Eurostat, ECB, Rederal Reserve, IBES, Worldscope, Pictet Asset Management. Data as of 06.11.2018.

Our **business cycle** analysis suggests global economic growth will continue to slow – to 3.3 per cent from 3.5 per cent in 2018 – amid softening survey evidence, a winding down of US fiscal stimulus and rising bond yields. Underlying inflationary pressure will pick up, particularly in emerging markets. We're forecasting global consumer price inflation of 3.0 per cent from 2.7 this year, with wage inflation already at a 10-year high across all major developed economies. A mix of slowing growth and rising inflation has historically been bad news for both bonds and equities, leaving cash the best alternative.

Central banks outside China will gradually turn off the **liquidity** taps during the coming year, setting the markets up for yet more ructions. Although monetary stimulus worldwide isn't expected to peak until the end of 2019, a dramatic reduction in net flows – to USD140 billion from USD2.6 trillion in 2017 – is bound to make its mark on risk assets. Excluding China, global central banks will, for the first time since the global financial crisis, be net sellers of financial assets.[2]

And given the dollar's primacy in the global financial system, all eyes will be on whether the US Federal Reserve doles out three more quarter point rate hikes rates, as most economists expect. Indeed, among the risks that worry us is the possibility of spike in US inflation that either forces Fed to act more aggressively or to shift to a new regime such as asset price targeting or rule-based rate setting. There's the additional risk that President Donald Trump's outspoken criticism of the Fed's hikes ends up being counterproductive if it prods the central bank to prove its independence by taking an increasingly hawkish stance. None of this forms part of our base-case scenario, but they are possibilities that are worth insuring against.

Equity **valuations** are broadly neutral after one of the biggest contractions in earnings multiples ever seen outside of recessions – the 12-month forward price to earnings ratio for the MSCI US index dropped from 19.2 times at the start of the year to a low of 14.9 times at the worst of the October market rout.

We see global corporate earnings rising by around 7 per cent in the coming year, which is slightly below consensus, with profit margins coming under pressure, primarily from rising wages and higher debt servicing costs. As a result, we expect the MSCI World All Country World Index to deliver negligible to flat total returns, with losses on US shares offset by other markets.

Meanwhile, growing inflationary pressures and a reduction in central banks' debt purchases are set to push up bond yields, particularly now that wages are at long last starting to respond to unprecedented labour shortages across all major economies. This matters for equities too. A 1 percentage point rise in US bond yields reduces the fair value of the S&P 500 by around 20 per cent on our discounted cash flow models – though for equity valuations, it's the gap between real bond yields and long-term EPS growth that matters. We think that a rise in 10-year Treasury yields to above 3.5 per cent would hurt equities from two fronts. Investors would be prompted to switch to bonds from shares. And rising yields would push up market interest rates, hitting borrowers and the economy more generally.

For now, our **technical and sentiment** indicators suggest the market shakeout that unfolded over the final months of 2018 seems overdone. Both global growth and corporate earnings may have peaked but there's no sign of an impending economic downturn. Yes, the global yield curve has inverted this year, but historically recession has only followed a year or two after that occurs. As a result many risk assets look oversold, leaving them ripe for a sharp rally, particularly into any good news. This could be a US-China trade deal, or hints from the Fed that it is in a position to slow policy tightening. In any event, equities' downside is limited by investors' bearishness.

[1] Chart based on a simple average of the following 10 macroeconomic and market indicators: Labour market = inverse of US unemployment rate; Yield curve = difference between US 10Y -2Y bond yield; Economic confidence: average of business, consumer, CEO, small business, real estate and investor confidence in US and EC Economic confidence indicator for euro zone; Equity valuation = 12-month forward price-earnings and price-to-book ratios (Source: Thomson Reuters Datastream); Margins = non-financial sector (Source: Worldscope); Inflation: core CPI YoY%; Policy rate : real US policy rate minus trend real GDP growth; Forward earnings: deviation from long-term log trend of IBES consensus US EPS forecasts; Bank loans: outstanding US bank loans to residents as % of GDP relative to linear trend. Data covering period 31.12.1989-16.11.2018.
[2] Source: Thomson Reuters Datastream, Pictet Asset Management

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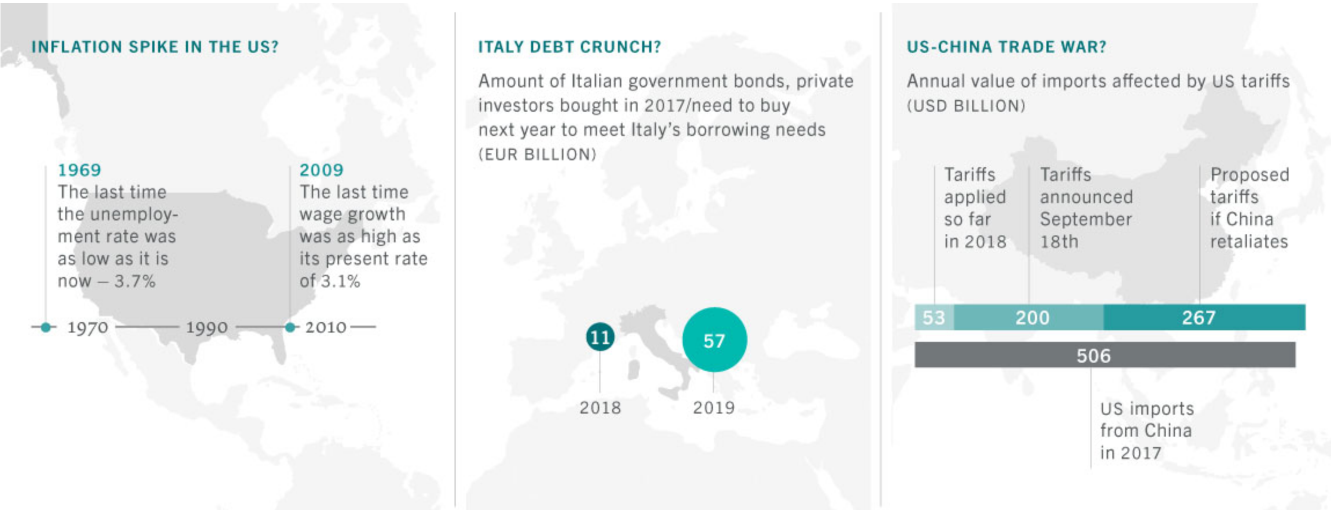
Trouble spots

In investment, it's generally adviseable to insure oneself against the possibility of adverse outcome, particularly those that lie within the regular realm of expectations. As we look ahead to 2019, three risks hove into view. The first is a faster than expected pick-up in inflation in the US, a development that could lead to a quickening in the pace of rate hikes. The second is political upheaval in the euro zone, triggered by a debt crunch in Italy. The third, and most concerning, is an escalation of the trade war between China and the US. So far, the economic impact of a hike in US import tariffs has been negligible but this could change if Sino-US relations worsen.

WHERE'S THE RISK?



Source: Bureau of Labor Statistics, Thomson-Reuters Datastream, Pictet Asset Management; data as of 20.11.2018

03

Equities: US on the ropes, defensive stocks standing tall

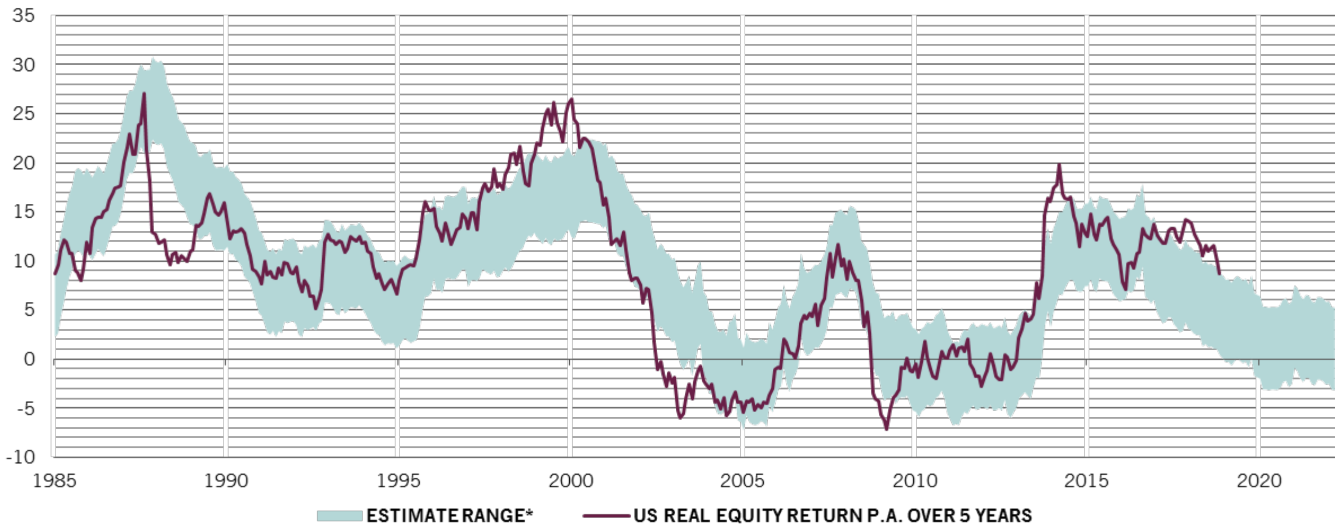
After enjoying a record-breaking nine-year bull run, the global equity market is likely to be flat next year, on a total return basis. Compared with 2018, the next 12 months promise lacklustre corporate profit growth.

We expect global company earnings to rise around 7 per cent next year, down from 13 per cent in 2018, as a slowdown in economic growth and an acceleration in wages will weigh on sales and profit margins that, in the US, are already at record highs.

US stocks should end 2019 in the red. Not only are they among the most expensive in the world, but a likely turn in US business, consumer and investor confidence and the potential for more monetary tightening set up a challenging environment.

We expect US corporate profit growth to more than halve next year from this year's 23 per cent, the biggest drop among major regions, also as the effect of Trump's tax cuts wanes. More importantly, long-term corporate profit expectations for American firms are likely to be downgraded for the first time in four years from the current level of 16.5 per cent, a 20-year peak.

END OF THE US REIGN?
Inflation-adjusted return of US stocks: actual versus estimated*



* Projection based on our macroeconomic assumptions of 1.8% real GDP growth, 2.6% average inflation and US bond yield at 3.5% in 2023, forecast range based on 75% confidence level. Source: Thomson Reuters Datastream, Pictet Asset Management, data as of 16.11.2018

Investors may do well to diversify away from the US into other developed markets, such as the UK and Switzerland, both of which have a relatively high proportion of defensive stocks in their benchmark indices.

We think defensive industries such as health care have potential to outperform economically-sensitive cyclical stocks, such as consumer discretionary and IT, whose unusually high valuations make them vulnerable to an economic slowdown.

Uncertainties over Brexit could in fact provide an attractive opportunity for foreign investors as the UK – one of the cheapest markets – is likely to benefit from a weak sterling. Japan could be another bright spot thanks to its attractive valuation, political stability, low corporate leverage and the yen, which tends to appreciate when risk aversion rises.

In contrast, we see limited upside for euro zone stocks next year. We are cautious over the region's economic prospects, not least because the Italian debt crisis has potential to escalate in the coming year at a time when the region’s economy is already slowing down. That said, investors should be able to uncover tactical opportunities in sectors such as financials and selective cyclical industries whose valuation has improved, such as energy.

In the emerging world, our favourite market is China, which offers the best value among its peers at a 12-month price/earnings of 10 times.

For all the concerns about the trade war and an economic slowdown, investor pessimism towards the world’s second largest economy looks difficult to justify at a time when Beijing is taking various steps to support growth.

The People’s Bank of China is the only major central bank that is still firmly in easing mode, set to provide what we estimate to be a USD350 billion of monetary stimulus in 2019 – equivalent to a 200 basis points cut in the reserve requirement ratio. The government is offering fiscal support by investing in infrastructure and cutting taxes for corporations and households, while implementing measures to stabilise the market and remove systemic risks.

Chinese companies in banking and consumer-related sectors, which have suffered the most during the 2018 market correction, should benefit the most from these support measures, and thus outperform in the coming year.

Elsewhere, we see limited upside in Latin America, where valuations are harder to justify, especially in Brazil, where we think newly-elected President Jair Bolsonaro will find it difficult to deliver his business-friendly policies.

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Fixed income and currencies: cautious on credit

Clouds are gathering over the corporate credit market. Valuations are firmly against it, with credit ranked as the most expensive asset class in our valuation model.

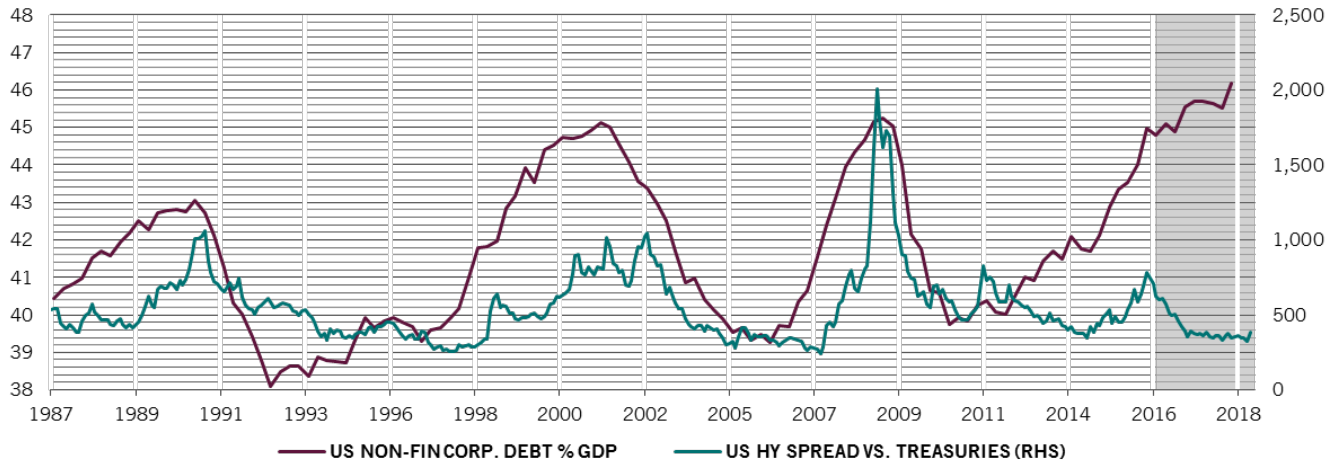
That is particularly worrying at a time when global central banks, led by the Fed, are tightening monetary policy. Credit has traditionally been the most vulnerable to interest rate hikes, but other fixed income assets will also be affected, with the potential for benchmark US 10-year Treasury yields to climb as high as 3.5 per cent during 2019 from around 3.1 per cent currently.

Furthermore, risks are building within the credit market itself: corporate leverage is edging up, bond issuance has been very high; the share of traditionally more short-termist retail investors is growing; and liquidity is low. Since the global financial crisis of 2008, the volume of outstanding US corporate bonds have doubled to USD5.5 trillion, while brokers' inventory of such debt has shrunk by 90 per cent to just USD30 billion.

Perhaps most worryingly of all, credit quality is deteriorating. Within the investment grade universe, the proportion of bonds with the lowest qualifying rating – BBB – has increased sharply over the past decade. Such paper now accounts for around half of the whole of the entire investment-grade market in both the US and Europe.

LESS PREMIUM FOR MORE RISK

US non-financial corporate debt as percentage of GDP and US high yield bond spread versus Treasuries



Source: Thomson Reuters Datastream. Data as of 06.11.2018.

In case of an economic slowdown or a rise in default rates, our models show that at least USD150 billion of bonds could be downgraded to high yield. The only way for the non-investment grade market to absorb such a large volume of **fallen angels** will be through price. Consequently, we think both investment grade and high yield bonds are riskier than their yields currently suggest. We are particularly cautious on Europe, where high valuations are more extreme than in the US.

In contrast, we believe that some of the best opportunities in the fixed income universe can be found in US inflation-linked bonds and – if the yield curve inverts as we expect – in 30-year Treasuries.

We also see value in emerging markets, particularly in Russia and South Africa, where high real yields offer a very good buffer against any broader fixed income turbulence.

Emerging market local currency debt should be a key beneficiary of the end of the dollar bull market in 2019. The greenback is currently some 20-25 per cent overvalued against EM currencies – one of the biggest dislocations seen in the past two decades – and we expect this gap to start to close.

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Appendix: forecasts

GROWTH SLOWING, INFLATION TICKING UP

Pictet Asset Management's growth and inflation forecasts, year-on-year, %

	GDP GROWTH		INFLATION	
	2018	2019	2018	2019
US	2.9	2.8	2.5	2.4
EURO ZONE	2.0	1.9	1.8	1.8
UK	1.2	1.4	2.5	2.2
SWITZERLAND	3.1	1.9	0.9	1.2
JAPAN	1.1	1.0	1.1	1.3
CHINA	6.6	6.4	2.1	2.4
EMERGING MARKETS	5.1	4.8	3.5	4.3
GLOBAL	**3.5**	**3.3**	**2.7**	**3.0**

Source: Pictet Asset Management. Data as of 02.11.2018.