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ASSET ALLOCATION

Equities offer greater potential than bonds, largely on valuation grounds. Liquidity conditions should remain supportive but uncertainty over the timing of a US interest rate hike will lead to higher volatility.

EQUITY REGIONS

Japanese stocks are the most appealing asset class;
European equities still look attractive, particularly in local currency terms.
In emerging markets, we prefer India.

EQUITY SECTORS

Consumer staples and other defensive sectors are expensive;
technology appears set to outperform.

FIXED INCOME

Emerging market debt remains our top pick for 2015.

The investment landscape in 2015

Pictet Asset Management Strategy Unit

Annual Outlook Barometer

Annual Outlook

Pictet Asset Management
Strategy Unit

Issued December 2014

Global overview

A moderately benign climate

"Red warning lights are flashing on the global economy's dashboard". It is hard to think of a more accurate way to capture the sombre mood permeating November's G-20 economic summit than the alert issued by UK Prime Minister David Cameron.

Investors might also find it hard to disagree with his views. Not only is the world economy troubled by a persistently weak euro zone, a recession in Japan and slowing growth in emerging markets, but its prospects are also hostage to worrying political developments, particularly Russia's worsening relationship with the West. Should a sharp downturn ensue in 2015, riskier asset classes would surely suffer while government bonds and the USD could add to this year's gains.

In our view, however, the investment climate in 2015 is unlikely to be as harsh as Mr Cameron's warning suggests. Although the global economy faces a number of obstacles, we believe it can avoid a steep downturn and deliver modest growth. Under our base-case scenario, equities should outperform bonds, with Japanese and emerging market stocks likely to lead the rally due to their attractive initial valuations. Emerging market debt should also fare well, in contrast to developed government bond markets, where historically low yields look increasingly hard to justify.

Sluggish growth but no recession

Global growth and inflation will remain below the historical norm in 2014. As we have argued in our Secular Outlook, world output will expand at a sub-par pace over the next several years chiefly because public spending cuts will continue to be a feature of government policy worldwide. There is little room to boost demand through fiscal stimulus – public debts have risen, not fallen, since the 2008 crisis.

Even so, growth promises to be better next year than it was in 2014. One reason is lower energy prices. With oil prices having fallen to their lowest levels since 2005 on an inflation-adjusted basis, consumer spending is certain to rise, which in turn should lift growth.

Indeed, we estimate that the oil price decline has already added as much as 0.5 percentage points to growth this year. Lower oil prices should also provide a boost for emerging economies, particularly export-oriented countries with large manufacturing sectors, cheap currencies and a clear reform agenda.

Another positive comes in the form of US capital expenditure. The potential for an increase in business investment in the country is rising as US corporate profits have been strong and business sentiment has improved.

We expect US capital spending to grow at the expense of share buybacks and dividend payments. Monetary policy should also help shore up growth. Although the US Federal Reserve is edging towards interest rate hikes, central banks elsewhere – the Bank of Japan and the European Central Bank in particular – are expected to act more aggressively to stave off deflation. This will ensure that central bank liquidity will expand at the same rate as it did in 2014.

With this in mind, we expect global growth to rise to 3.2 per cent from 2.7 per cent this year; the US will be the best-performing major economy, registering growth of some 3 per cent; output will edge up by 1.1 per cent in the euro zone and by 1.5 per cent in Japan. Emerging markets will grow at 4.8 per cent, up from 4.4 per cent in 2014.

FIGURE 1 – OUR GROWTH AND INFLATION FORECASTS

	GDP growth		Inflation	
	2014	2015	2014	2015
US	2.1%	3.0%	1.8%	2.2%
Euro-area	0.7%	1.1%	0.6%	1.2%
UK	3.0%	3.1%	1.6%	1.7%
Switzerland	1.1%	1.6%	0.0%	0.2%
Japan	1.3%	1.5%	1.3%*	1.2%*
China	7.3%	7.4%	2.1%	2.4%
Emerging Markets	4.4%	4.8%	4.7%	4.6%
Global	2.7%	3.2%	2.7%	2.9%

Source: Pictet Asset Management

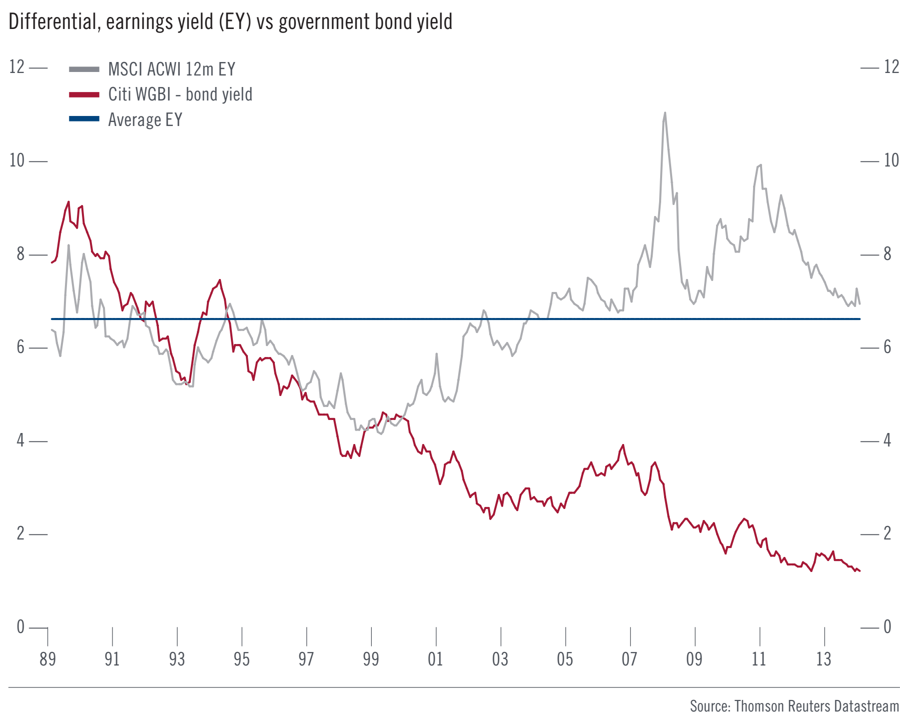
Asset allocation

Valuations favour equities over bonds

When it comes to assessing the investment prospects for equities and bonds, it is impossible to ignore the initial valuations of each asset class. By this yardstick, stocks offer greater potential than fixed income in 2015. Our valuation model[1] shows that developed markets equities are not especially expensive, trading at around fair value. Emerging market stocks, meanwhile, are well below their fair value. This is in contrast with fixed income where valuations look unappealing, except emerging debt. Also favouring equities is that, compared to bonds, they are extremely cheap. At around 6 percentage points, the gap between stocks' earnings yields and government bond yields – a gauge of the extra return investors should expect to gain from equities – is at historically high levels

This is not to say returns from equities will be especially high in 2015. We expect gains to be modest – in the single digit range – not only because corporate profit margins are unlikely to expand but also because a less dovish Fed will also weigh on investor sentiment. Liquidity should remain supportive for equities overall, but uncertainty over the timing of the Fed's first interest rate hike will probably lead to higher volatility.

FIGURE 2 – EQUITIES ARE ATTRACTIVELY VALUED VERSUS BONDS



Source: Thomson Reuters Datastream

[1] The model is based on an historical analysis of the gap between stocks' earnings yield and government bond yields and price-to-book ratios.

Equity region and sectors

Developed market stocks: Japan and cheap cyclicals to shine

Our preferred developed world stock market for 2015 is Japan. Japanese stocks are attractive on several fronts.

First, export-oriented companies stand to benefit from the weak JPY, which is trading below its purchasing power parity rate for the first time ever.

Second, domestic stocks should receive a strong boost from a change in investment policy at Japan's biggest public pension fund, the GPIF, which is to increase its allocation to Japanese equities to 25 per cent from a current target of 12 per cent.

Third, the BoJ has expanded its bond purchase programme, which should prove supportive for growth and stocks (Fig. 3).

Lastly, reforms set in motion by Prime Minister Shinzo Abe promise to lead to a considerable improvement in the country's corporate governance.

Europe is another potential bright spot, especially over the near term. Although the economy continues to struggle, we believe the investment climate for stocks should improve as the ECB is becoming ever more aggressive in its bid to avert deflation.

What is more, the weak EUR should translate into strong export growth, which in turn could boost corporate earnings. Indeed, it is worth noting that the third quarter of 2014 delivered the strongest set of corporate profits since the beginning of 2011.

What is more, with investor positioning in European stocks having become extremely bearish over the past

few months, the potential for a recovery is increasing.

When it comes to industry sectors, defensive areas such as consumer staples, health care and telecom offer limited investment appeal – not only do they tend to lag when growth picks up (however modestly) but valuations in these sectors are also high compared with their cyclical counterparts. Instead, we prefer technology and industrials. These cyclical sectors look reasonably priced on a range of valuation metrics, including price-earnings and price-to-book ratios, and are also less sensitive to rising bond yields or falling commodity prices.

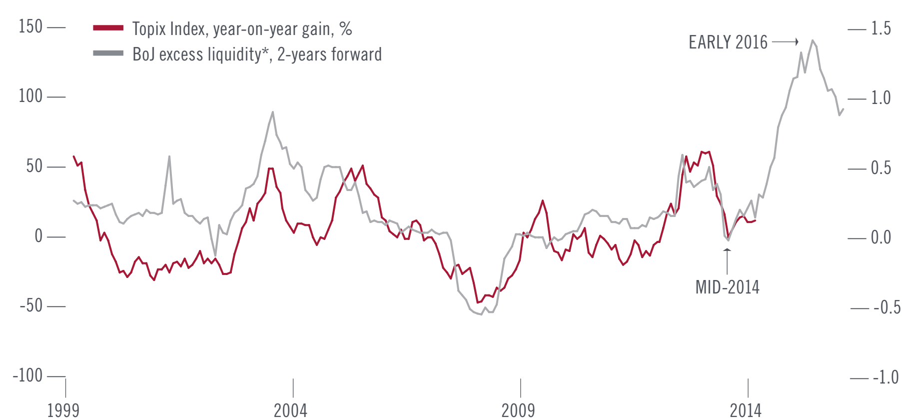
Emerging market equity: recovery, but an uneven one

The prospects for emerging market stocks also look reasonable on the whole but the recent fall in the price of oil and other commodities is a mixed blessing for the asset class.

Broadly speaking, valuations are positive. On a price-earnings basis, emerging stocks are 25 per cent cheaper than their developed market counterparts. That gap should narrow over the course of 2015 as emerging market manufacturers become more competitive thanks primarily to a fall in their base currencies but also to an improvement in their productivity. Any pick-up in world trade would also disproportionately benefit emerging markets.

Even so, the dispersion in the returns of the individual stock markets that make up the major emerging market equity indices is likely to widen further in 2015, extending the trend that began in 2010. Markets that are home to companies that benefit from falling oil prices (Korea, Taiwan) look better positioned than those that are dominated by commodity exporters (Russia, Brazil).

FIGURE 3 – BOJ STIMULUS COULD PAVE WAY FOR STOCK MARKET RALLY



*Pictet Asset Management proprietary leading liquidity index, a gauge of BoJ net liquidity provision

Source: Pictet Asset Management

Fixed income

Testing times for developed market bonds; EM debt prospects improving

In our view, developed market bonds look especially vulnerable to a sell-off.

One reason is fundamentals. Bond yields in many markets are hovering close to their lowest levels on record yet issuers' credit quality has steadily deteriorated in recent years. Since 2005, developed world sovereign borrowers' credit standing has weakened: just nine countries are rated triple-A by Standard & Poor's, down from 16. The picture is similar for corporate bonds. Last year, companies with ratings of BB+ and lower accounted for 21 per cent of total issuance, compared with 10 per cent in 2005. Also clouding the outlook for developed government and corporate bonds (both investment and high-yield) is the steady withdrawal of US monetary stimulus, which could counter the positive effects of further quantitative easing in Japan and the euro zone.

The prospects for emerging market debt are more promising. Local currency bonds should benefit from a recovery in emerging currencies, which our model shows are trading some two standard deviations below fair value (Fig. 4).[2] Bond valuations are also attractive - the yield differential between emerging market local currency and developed government debt is – at around 500 basis points – far above the long-term average.[3] Valuations aside, monetary policy should also provide some support – we believe a growing number of central banks will take advantage of a decline in inflationary pressures

[2] Our currency valuation model incorporates three key economic variables: a country's relative productivity, its net foreign assets position and its inflation trajectory
[3] Yield gap is the difference between the aggregate yield on the JPM GBI-EM global diversified local emerging bond index and the Citigroup WGBI

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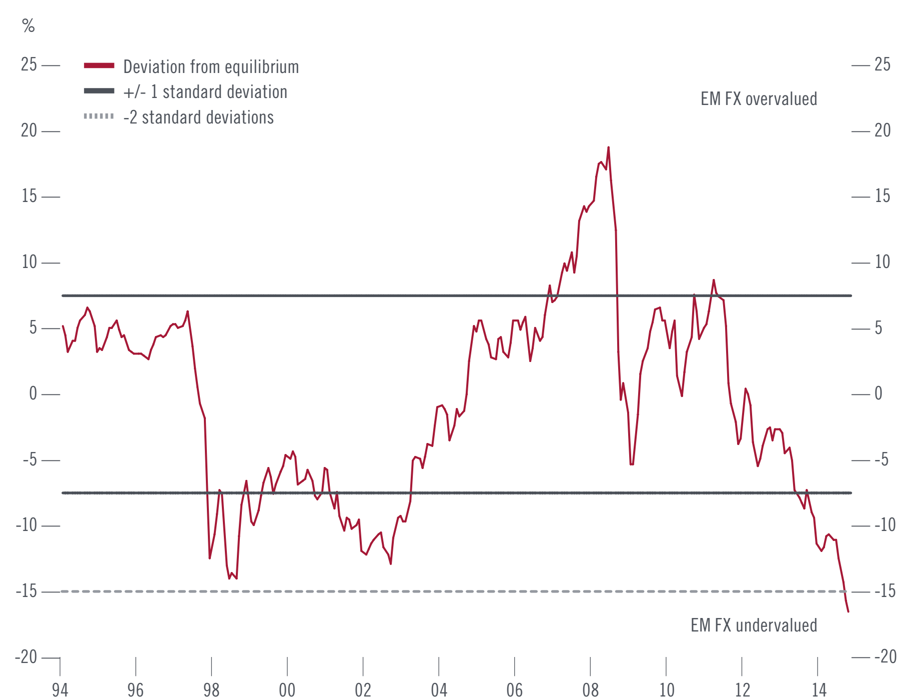
to shift to a more dovish stance next year to cement growth. China's recent interest rate cut is part of this trend.

Dollar appreciation to slow

The past 12 months have seen the USD rally to a four-year high against a basket of major world currencies as the US economy continued its recovery and the Fed brought quantitative easing to a close. By our reckoning, the currency is already considerably overvalued. Our model indicates the currency is some 1.5 standard deviations above fair value; it is also some 11 per cent above the long-term, trade-weighted, trend. Its appreciation should therefore slow in 2015.

FIGURE 4 – EMERGING CURRENCIES TRADING WAY BELOW FAIR VALUE



Source: Pictet Asset Management

Risks to our base-case scenario

1. Deflation becomes entrenched in the euro zone, sparking concerns over the public finances of the region's most heavily-indebted countries
2. A policy mistake by the Fed – either in the shape of a premature interest rate hike or unclear forward guidance
3. China's property market experiences a sharp slowdown
4. Geopolitical risks rise - a further deterioration in the West's relationship with Russia or further political unrest in EU countries with high unemployment

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, historical earnings multiples
- **sentiment:** Pictet sentiment index (investors' surveys, tactical indicators)

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