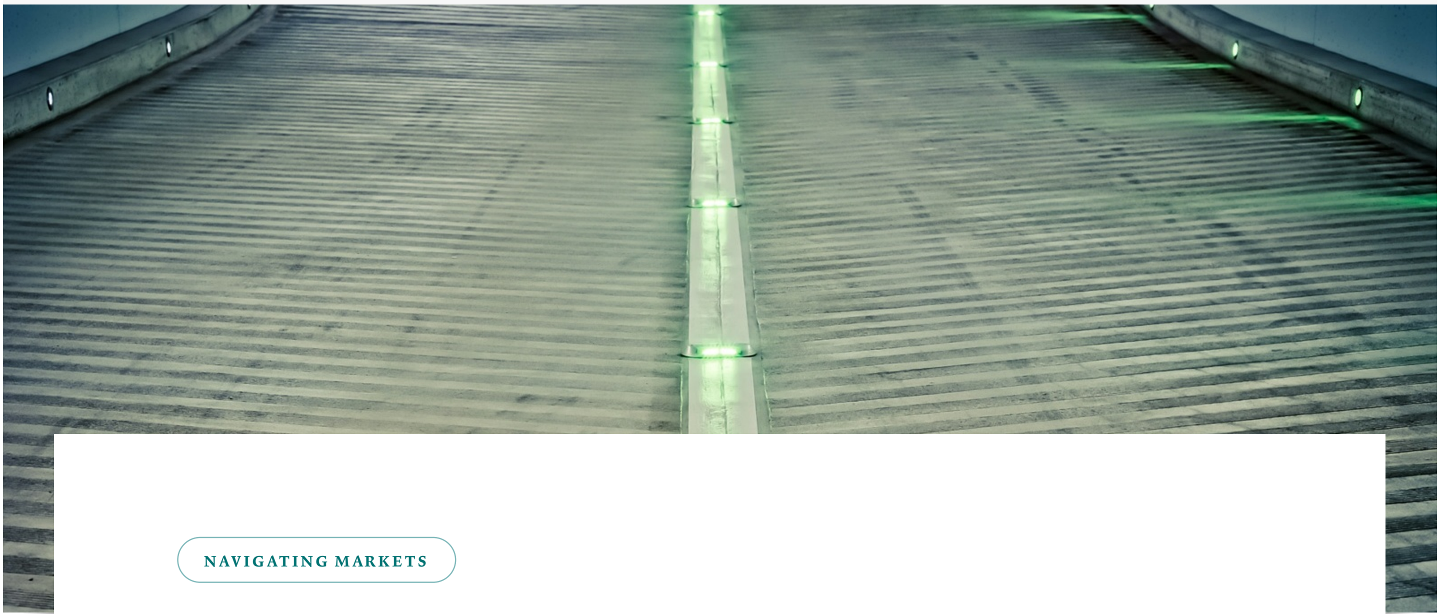

NAVIGATING MARKETS

The investment landscape in 2017

December 2016

Pictet Asset Management Strategy Unit

Buckle up for 2017: political turmoil, inflation and tighter financing conditions look set to compete with improving growth and corporate earnings.

Key points

- The current environment is challenging for equities but potentially pretty grim for bonds and bond-like dividend-paying stocks.
- The winners in this climate should include cyclical shares as well as traditional hedges against volatility and inflation, such as gold, the VIX and inflation-linked bonds.
- We also think it is prudent to go into next year with ample holdings of cash – both as insurance against market falls and, arguably more importantly, to be ready to take advantage of any dislocations and mispricing that could follow from political upsets or

policy actions.

Headwinds for equities

Bad news for equities includes tightening liquidity conditions, political upheaval and the return of wage inflation.

> “Even a low-intensity trade war stoked by the new US administration can do long-term damage.”

The risk of protectionism is extremely difficult to price but even a low-intensity trade war stoked by the new US administration can do long-term damage to equities, especially for emerging markets and for large-cap companies with substantial global supply chains.

US stocks are close to being the most expensive ever versus Japanese and European peers so a marked further outperformance is unlikely unless markets enter a risk-off phase or the dollar depreciates markedly.

European equities cheap but wait until H2

European stocks are trading at discount to the US based on the 12-month price-to-earnings (PE) ratios. But while European equities could present an attractive investment opportunity in the medium term, for now there are good reasons for the hefty risk premium.

> “For now there are good reasons for the hefty risk premium in European equities.”

In particular, we would highlight the potential for large scale recapitalisations in the banking sector. An even bigger issue is regulation, with European domestic institutions, such as insurers, restricted in their ability to sell bonds and buy equities. That means the impetus for a market rebound will need to come from foreign investors. This is unlikely to happen while there are still uncertainties over both ECB policy and the outcome of various European elections.

By the second half of 2017, these risks may well have cleared, paving the way for a reversal in the extremely negative sentiment and thus for a market rally.

Japan appears a buy

We think Japan is worth buying now – not just because it is the cheapest developed stock market in our model but also because of its positive economic prospects.

EM equities: favourable long term outlook

We are bullish on the long-term outlook for emerging markets due to their attractive valuations, structural reforms, a recovery in commodity prices and healthy investment flows. However, the recent sell-off highlights the vulnerability of this asset class to trade concerns, a surging dollar and tighter financial conditions.

On balance we think that EM stocks should outperform next year on improving fundamentals and we would look to selectively add to our exposure there. Regionally, emerging Europe and Asia look the cheapest, trading at close to a record low compared to Latin America.

Equity sectors: favour cyclicals, financials

When it comes to equity sectors, cyclical stocks are in general well-positioned for the coming year, despite their recent rally. If nominal GDP growth and corporate earnings accelerate as we expect, cyclical stocks should rally to trade in line with their long-term 10 per cent premium to defensive stocks.

This compares to the current 4 per cent premium and 10 per cent discount in early July. Capex related stocks should perform particularly well as corporations step up investment. Financials shares, meanwhile, are set to benefit the most from global reflation due to their cheap valuations and their tendency to respond positively to a steeper yield curve.

Bonds to suffer from rising inflation and tighter policy

US bonds look under pressure with inflation is on track to top 2 per cent for the first time since 2014. Trump's policies are likely to add to inflationary pressures through tax cuts and public spending increases.

> “Trump's policies are likely to add inflationary pressures.”

They are also likely to prompt greater monetary policy tightening than previously expected from the Fed, in turn leading to higher US government bond yields and a steeper yield curve.

We also see bond yields moving higher in Europe where the risk of tighter central bank policy is underappreciated. European bonds also look very expensive compared to their US counterparts.

EMD could be a bright spot

Favourable view on 'linkers'

With global producer price inflation surging to five-year highs, inflation- linked bonds are starting to look attractive again but we continue to think that gold is a better hedge in the long-term.

US dollar to be largely range-bound, sterling and UK assets look undervalued...

The dollar could strengthen further in the next few months due to stronger US growth and the Fed signalling more hikes than are currently priced in.

> “In the short term the UK economy and assets are likely to exceed expectations.”

But over the course of 2017 as a whole we expect a very volatile, range-bound performance, with the dollar currently circa 20 per cent overvalued on our models.

Sterling, meanwhile, looks cheap following the steep depreciation since the Brexit vote. The exchange rate is now consistent with fairly dire economic growth. While weak growth may materialise eventually as Britain progresses with the EU exit, we believe that in the short term the UK economy and assets are more likely to exceed expectations.