PICTET
Asset Management

BAROMETER OF FINANCIAL MARKETS DECEMBER INVESTMENT OUTLOOK
December 2021

Barometer: No reason for pandemic panic

While financial markets are unsettled by the emergence of the Omicron Covid variant, investors shouldn't panic. Economies are better equipped to deal with a new wave of infections.

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Asset allocation: re-opening remains on track

Riskier asset classes are trading at or close to all-time highs. There are good reasons for this.

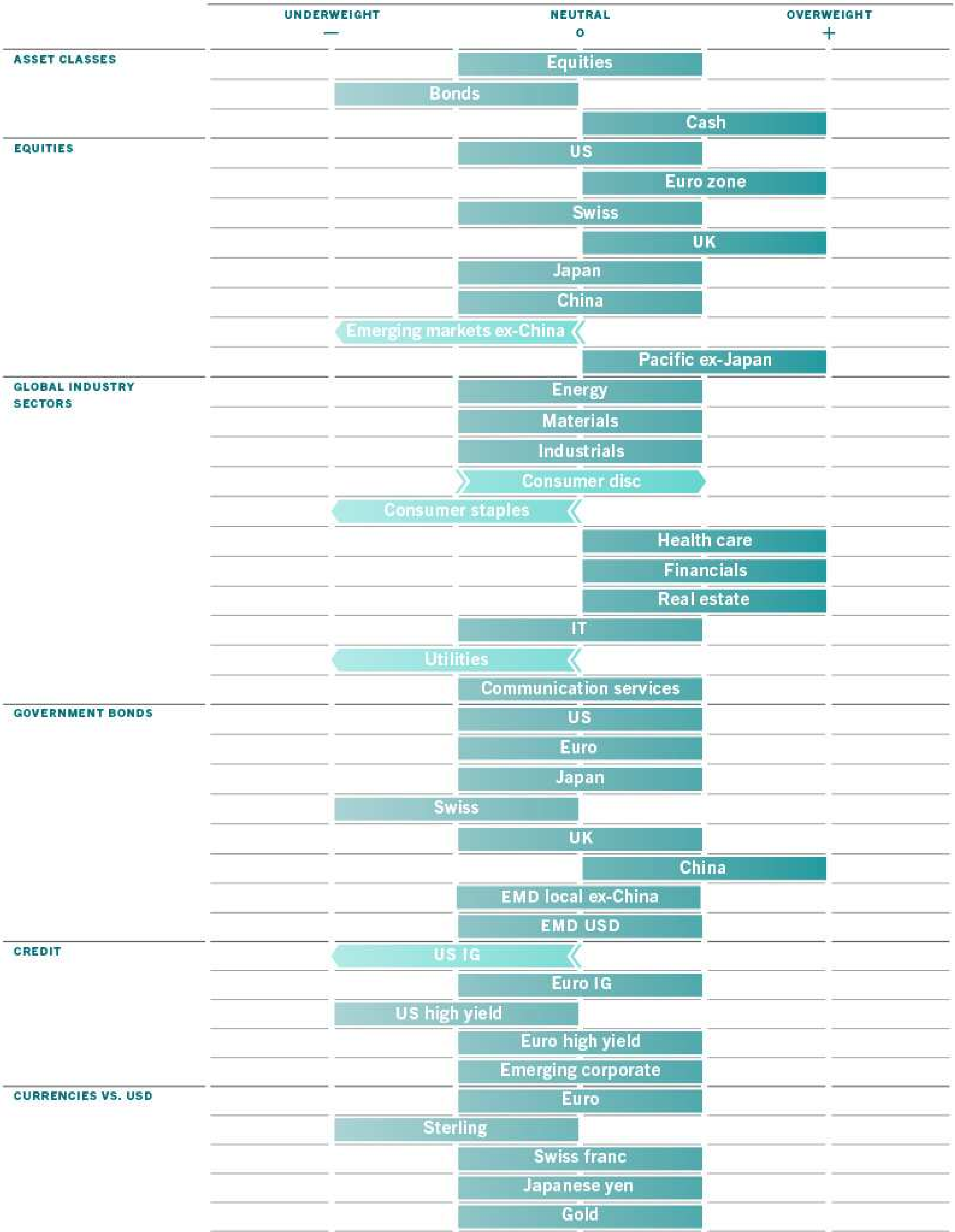
Consumer and industrial demand is robust, supply bottlenecks look set to ease – potentially placing downward pressure on inflation – and corporate earnings and margins remain healthy.

This augurs well for equity markets over the near term.

And yet this positive picture needs to be balanced against a the emergence of a new threat to the economy. Though it had fallen right down the list of investors' worries, the recently identified Omicron variant of Covid shows the pandemic hasn't faded away. While pandemic-related developments can no longer dictate the economic cycle, they can certainly influence it.

Fig. 1 - Monthly asset allocation grid

December



Source: Pictet Asset Management

Markets were clearly spooked by the emergence of a new Covid variant classed as "very high" risk by the World Health Organization. While the unprecedented number of mutations in the strain suggests that the virus could evade current vaccines to some degree, this has yet to be established.

Also unclear is the severity of the disease the new strand causes, even if anecdotal evidence is encouraging.

For their part, governments aren't taking risks. Many have imposed travel restrictions, perhaps learning lessons from the dithering they were guilty of during the spread of the Delta variant earlier in the year.

But the picture is not universally negative.

Although Covid has caused distortions and supply bottlenecks, economies have by and large adapted remarkably well to the vagaries of the pandemic and are now are better prepared to withstand its effects.

Also, it appears that the vaccines that have been rolled out globally can be modified to target the new variant.

At the same time, we see no signs of 'froth' in the shares of companies that would have benefited from a full re-opening of the economy. Valuations for Covid-sensitive stocks suggest investors had been largely sceptical of the prospect of a smooth, hiccup-free reopening of the economy.

So, despite the heightened uncertainty, we believe the direction of travel is still towards the reopening and near-normalisation of economies worldwide.

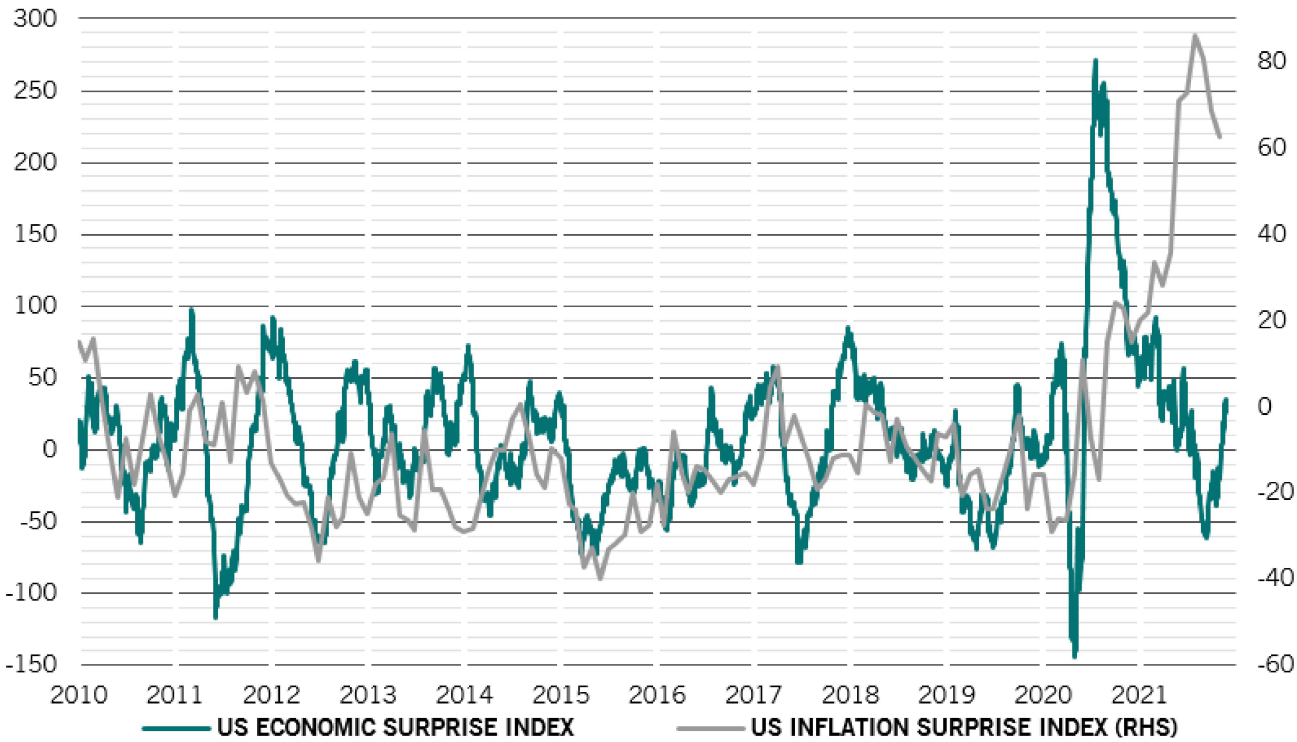
All of which leads us to maintain a neutral positioning on equities and remain negative on bonds.

Overall, our **business cycle** indicators show the economy continuing to recover from the pandemic. Notwithstanding concerns about short-term risks to European growth, largely related to fresh lockdowns and a new surge in Covid cases, we are more confident on how economic conditions are shaping up in the developed world.

US growth can be expected to remain very strong in both real and nominal terms (see Fig. 2). Worldwide, we expect services industries to gain momentum. Under normal conditions, services sectors would typically follow the lead of manufacturing – which has shown some softening lately. However we believe the next phase of the recovery will be powered by services as the reopening of economies should remains by and large on track (albeit with the added uncertainty due to the spread of the Omnicron variant).

We forecast a sequential re-acceleration in growth through to the first half of 2022. The pace of global economic expansion should remain above-trend for the foreseeable future – our forecast of 4.8 per cent GDP growth next year remains above consensus.

Fig. 2 - Unsurprising
US economic surprise vs. inflation surprise indices



Source: Refinitiv, Pictet Asset Management. Data from 31.12.2005 to 24.11. 2021

Our **liquidity** indicators show a significant contraction in credit supply this quarter, thanks to a sharp withdrawal of central bank stimulus. More positively, however, there are signs of credit supply growing in the private sector, particularly in the US, while the Chinese authorities are also starting to relax their stance.

The pickup in private borrowing has historically put upward pressure on interest rates, as it allows central banks to tighten even faster.

Our **valuation** indicators show that all major asset classes remain expensive by historical standards, with equities hovering at all-time highs. One exception is Latin America, whose equity markets are now cheap even in absolute terms. In relative terms, the UK is also good value.

US stocks are the most richly priced. And consumer discretionary stocks are beginning to look as expensive as technology shares. Meanwhile, cyclical stocks have outperformed their defensive counterparts as inflation expectations have increased; this has taken cyclical stocks' premium over defensives back close to cycle highs of 16 per cent.

A decline in liquidity and upward pressure on real yields will reduce stocks' price-earnings ratios, though about half the contraction we envisaged earlier this year has already occurred. Meanwhile, though the a surge in profit growth looks to be easing, we still expect corporate earnings to rise 16 per cent for the coming year.

Within fixed income, the signal on Chinese government bonds is neutral while US investment grade bonds appear expensive. Surging inflation has triggered a flight into US inflation-linked bonds, leaving them with yields below -1.0 per cent and the second most overbought asset class in our models.

Our **technical** indicators show that positive trends for global equities intensified, compensating for an absence of positive seasonal factors. Technical readings for bonds were negative although surveys show investor positioning in fixed income appears excessively bearish, which would normally be a 'buy' signal.

02

Equities regions and sectors: resilient earnings

Rising Covid cases, supply chain bottlenecks and inflation concerns have taken their toll on global economic growth in recent months. But we find reasons for optimism. There are signs supply constraints are beginning to ease and we believe inflationary pressures should peak in the coming months, before moderating through the rest of 2022. As a result, we anticipate a fresh burst of growth and – crucially – a long-awaited recovery in the services sector, although frustrated to some degree by the emergence of the Omicron variant of Covid.

That growth spurt should prove a boon for parts of the equity market which are most exposed to the economic cycle and support corporate earnings. In fact, we are optimistic about corporate profits across most regions, reflecting our above-consensus views on economic growth. Globally, we see profits rising by 16 per cent next year, compared to analyst consensus of approximately 7 per cent. Stronger-than-consensus profit growth is more likely in the euro zone and Japan (where the economic recovery is still incomplete).

We have consequently become more positive on prospects for consumer discretionary stocks, upgrading the sector to neutral from negative. Consumption appears to holding up well despite higher prices – particularly in the US. The supply constraints affecting the auto sector, meanwhile, should soon begin to ease. Earnings revisions for such companies relative to the market are what we consider to be trough levels, suggesting profit upgrades are likely over the coming months.

We also like real estate, which is one of the cheapest sectors in our valuation grid, relative to its own 20-year history; such stocks can also serve as a partial inflation hedge. Financials remain our preferred sector for several reasons. Despite its strong rally this year, it remains attractively valued, bank profitability looks set to improve as bond yields rise and hurdles to dividend distribution have been largely removed by regulators.

We are more cautious on defensive sectors, whose relatively strong performance in recent months is vulnerable to any pick-up in economic growth. We have downgraded both utilities and consumer staples to underweight from neutral. Both sectors are essentially bond proxies, which means they could struggle as bond yields rise. Utility companies may come under increased pressure from governments seeking to contain energy price rises. Consumer staples, meanwhile, are a play on the growth of emerging economies, whose prospects do not appear particularly positive over the near term.

Fig. 3 - Closing the growth gap
Growth differential between emerging and developed economies versus stock market performance

Source: Refinitiv, Pictet Asset Management, data covering period 31.12.1990 – 22.11.2021; Pictet Asset Management forecasts given for 2022-2025.

With US growth expected to remain strong in both real and nominal terms, the hurdle for any outperformance of emerging market stocks is very high when adjusting for their risks. As Fig.3 shows, emerging market stock returns have suffered as economic growth in the developing world has lagged that of the developed world. Also, we expect the economic outperformance of the US and the policy divergence between the Fed and the more dovish ECB to keep the dollar bid - something that typically weighs on the returns of emerging equities.

We therefore downgrade emerging market equities (ex-China) to underweight. A rotation back into emerging market stocks is likely in the second half of next year, but this is dependent on an improvement in economic conditions and either an end to - or a significant slowdown in the pace of - monetary tightening across the developing world.

03

Fixed income and currencies: braced for volatility

The investment climate for most fixed income assets is unlikely to improve anytime soon.

Lingering inflation and central bank efforts to withdraw monetary policy stimulus should lead to higher bond yields.

Complicating matters further, volatility in the government bond market has also picked up sharply through the year as a result of shifting central bank policies.

Moreover, we expect the yield curve to flatten further next year, particularly in the US. Investors, therefore, do not gain any excess compensation for inflation risks through longer-maturity bonds. We therefore maintain our underweight stance on the asset class.

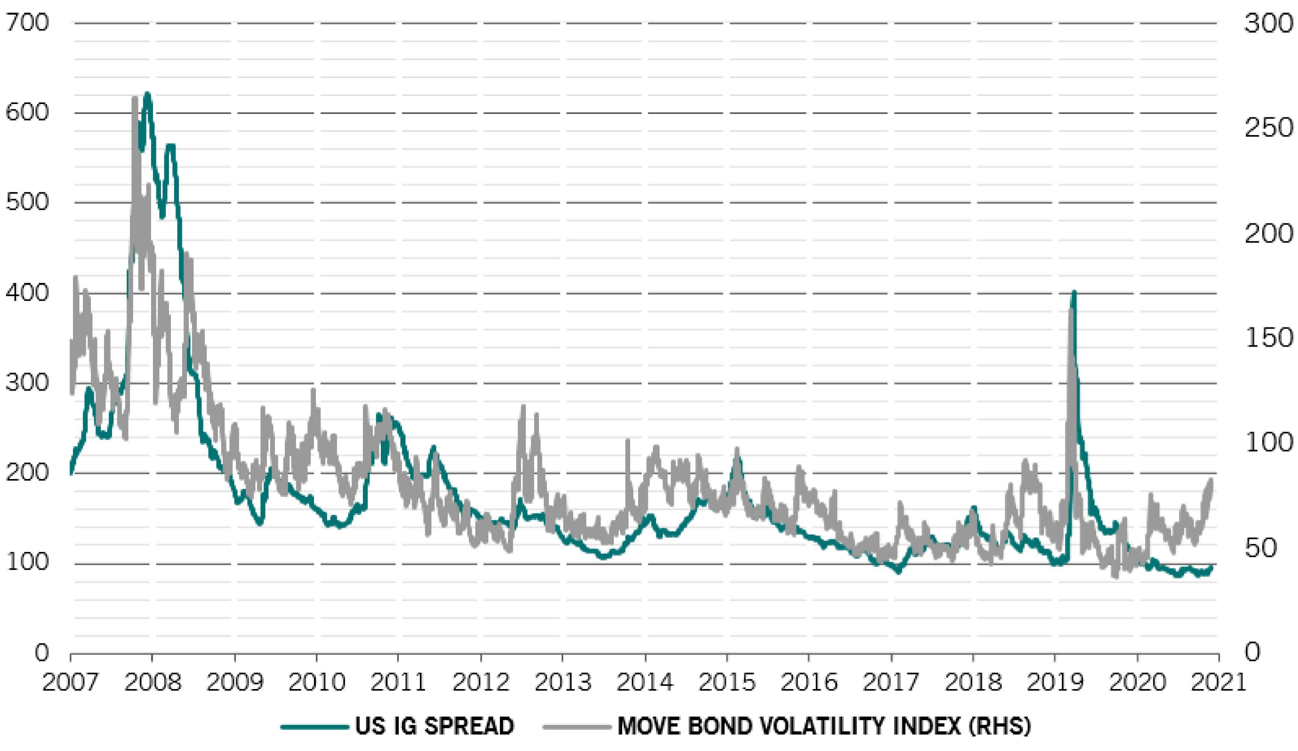
Within credit, we have downgraded US investment grade bonds to underweight. Valuations are excessive. The difference between US investment grade yields and US Treasuries stands near a record low of 96 basis points.[1]

It is a thin buffer, offering little protection against any unforeseen bought of economic weakness, leaving the asset class vulnerable (see Fig. 4). Even in a constructive scenario in which economic growth remains healthy, we expect total returns for investment grade bonds to be negative in the coming year as our models suggest US 10-year yields will edge towards 2 per cent.

What is more, US investment grade bonds have a longer duration than their European peers, which make them unattractive on a relative basis.

Fig. 4 - Priced for perfection

US Investment Grade spreads near record low even as bond volatility rises



Source: Refinitiv, ICE, Bofa, Pictet Asset Management, data covering period 31.12.2017 – 24.11.2021

The picture is equally negative for US high yield debt –which remains by far the most unattractive asset class on our valuation scorecard; we remain underweight.

The only bright spot in fixed income is Chinese government bonds, in which we remain overweight. They offer attractive yields and have proven diversification benefits. At the same time, inflationary pressures in China are relatively muted.

What is more, Chinese bonds are denominated in a currency that we believe should appreciate over the long-term thanks to powerful structural trends. The Chinese renminbi hit a six-year high on a trade-weighted basis thanks to a high current account surplus and capital inflows.

In the most recent month, Chinese bonds attracted investment inflows of USD6.3 billion.[2]

Elsewhere, we remain neutral across almost all government debt, except for Swiss bonds where we retain an underweight stance.

Within currencies, we expect the dollar to strengthen for a while longer, although gains will likely be limited by an-already rich valuation and what appears to be excessively bullish investor positioning in the currency.

The dollar is most likely to outperform again sterling. The UK economy is under pressure from supply constraints and there is increased uncertainty around whether the Bank of England will raise interest rates this month to contain inflation.

[1] Refinitiv, data as of 24.11.2021

[2] Institute of International Finance, data as of 02.11.2021

04

Global markets overview: Omicron fears

Equities ended the month in the red as concerns over the new Covid variant and a warning that current vaccines may not be as effective triggered selling across risky asset classes.

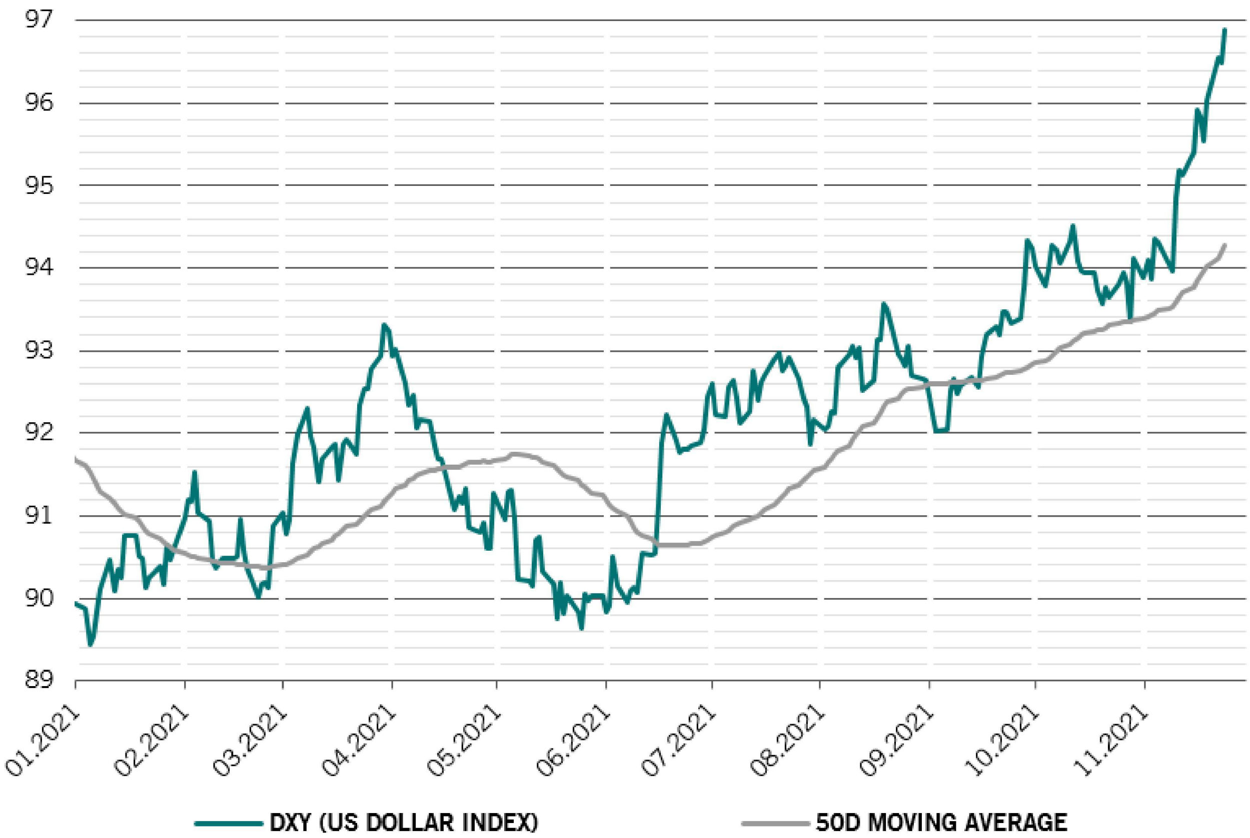
Moves by some European countries to reintroduce mobility restrictions also clouded the outlook for the global economy, weighing on oil and commodity prices which lost more than 10 per cent in November.

US stocks fell 1 per cent on the month and are now down 3 per cent from all-time highs. A bulk of selling coming towards the end of the month after Fed chairman Jerome Powell suggested the central bank could accelerate the pace of tapering monthly bond purchases, which could result in earlier-than-expected interest rate hikes.

US stocks, however, remain the best performing market in 2021 with year to date gains exceeding 20 per cent.

The dollar rose a further 2 per cent against a basket of currencies in the month, extending this year's gains to nearly 7 per cent.

Fig. 5 - Dollar's days
US dollar index and its 50-day moving average



Source: Refinitiv Datastream. Data covering period 31.12.2019-24.11.2021.

Swiss stocks ended the month virtually flat, outperforming other markets thanks to the country's high share of defensive stocks.

Emerging assets – both equities and bonds – fell in the face of a stronger US dollar. Uncertainty over China's economy, which is grappling with slowing private investment, property-sector debt and regulatory crackdowns, also weighed on broader emerging markets. This comes at a time when more emerging central banks– such as Korea and South Africa – have started raising interest rates.

Among sectors, energy stocks were the biggest losers with declines of more than 5 per cent. IT was the only bright spot as it gained nearly 3 per cent thanks to strong earnings results.

Utilities, materials and consumer discretionary avoided the worst of the selling pressure with a decline of just over 1 per cent.

In fixed income, UK bonds rose more than 3 per cent and yields on 10-year UK government bonds registered their biggest one-day fall since the onset of the Covid crisis in March 2020 as investors reduced bets on aggressive interest rate hikes from the Bank of England. The yield on the 10-year inflation-linked gilt fell to a record low of -3.34 per cent.

High yield bonds on both sides of the Atlantic fell as investors sought to reduce risk.

Most currencies fell as the dollar rose across the board. The yen gained 0.8 per cent, attractive safe-haven flows; the Chinese renminbi also rose.

The Turkish lira lost more than 27 per cent as the country's President Recep Tayyip Erdogan defended the central bank's interest rate cuts despite inflation surging above 20 per cent.

05

In brief

BAROMETER DECEMBER 2021

Asset allocation

We remain neutral on equities and underweight bonds. There are reasons for optimism about growth but pandemic risks remain.

Equities regions and sectors

We reduce exposure to consumer staples and utilities, preferring more cyclical sectors.

Fixed income and currencies

We downgrade US investment grade to underweight, we remain overweight in Chinese bonds.

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