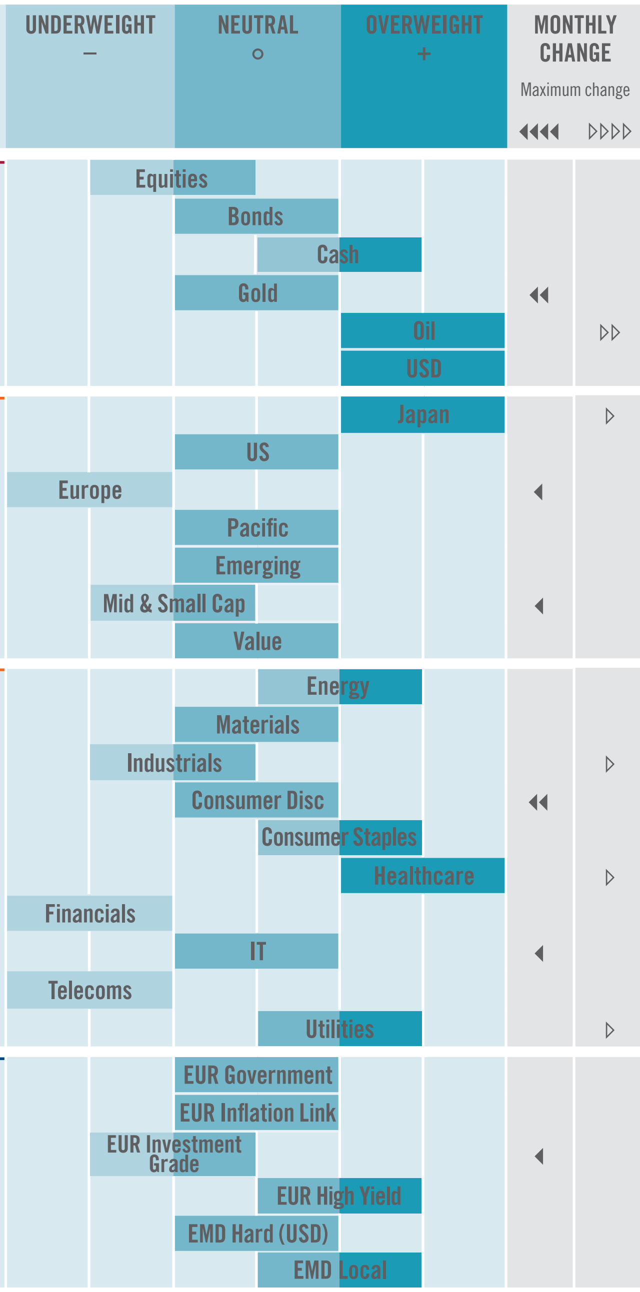
PICTET 1805



GLOBAL ASSET CLASSES
We stick to our underweight stance on equities and retain our overweight in cash as investor optimism appears excessive.

EQUITY REGIONS AND STYLES
We remain tactically overweight Japan as we believe the appointment of a new BOJ governor will set the stage for more pro-growth policies.

EQUITY SECTORS
We take profit on the consumer discretionary overweight, and shift to neutral as the sector is trading at all-time highs; we have upgraded industrials to a single underweight.

FIXED INCOME
We remain long high-yield bonds and local currency emerging market debt; we reduce investment grade credit to underweight.

The best is behind us

Pictet Asset Management Strategy Unit

Monthly euro investor outlook on a 3 month view

Barometer

February 2013

Monthly outlook

Pictet Asset Management
Strategy Unit

Issued 4 February 2013

Global market overview

Investors convinced of recovery

Riskier asset classes gained in the first month of 2013 and government bonds saw sharp declines as investors were confident that the ultra-easy monetary policies of major central banks were beginning to fuel a recovery in world growth. Markets were buoyed by US employment figures, Japan's plans to deliver a fiscal and monetary boost to shore up its economy and the fact that both Spain and Portugal successfully completed government bond auctions. A potential setback came in the shape of an unexpected decline in fourth quarter US GDP, but with the underlying figures showing a solid increase in business investment, investors took the news in their stride.

European equities were among the best performers, closely followed by US and Japanese stocks. Value and small-cap stocks also fared better than the broader market. The pattern of returns across sectors, meanwhile, was not entirely consistent with a risk-on shift in investor sentiment. Health care stocks delivered the best gains while information technology, a sector that fell victim to signs of a sales slowdown at Apple, lagged the market by a wide margin. The degree of correlation among individual stocks continued to fall, building on a trend that first emerged towards the end of 2012, suggesting investors were paying closer attention to idiosyncratic risks.

Amid growing optimism over world growth, yields on US Treasuries and Bunds ratcheted higher and investment grade credit also sold off. The only bright spot in fixed income was high-yield debt, which built on the strong gains it delivered in 2012. In currency markets, the Japanese yen and sterling lost ground while the euro gained. In emerging markets, meanwhile, the Brazilian real headed higher while the South Korean won headed south.

Asset allocation

Staying short as markets overshoot

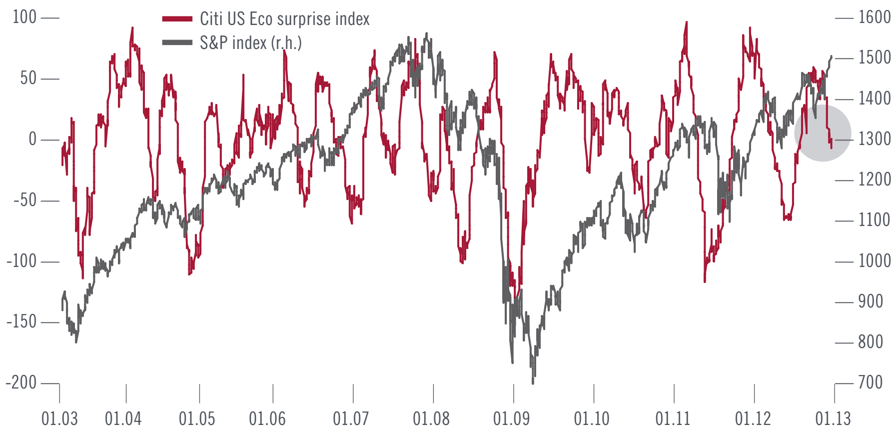
Although it appears that economic growth is gathering some momentum - our proprietary leading indicator rose for the first time in eight months in December - the strong bounce in riskier asset classes has taken valuations to lofty levels. This, coupled with some sharply negative readings from some of our sentiment indicators, has discouraged us from adopting a more positive stance on equities; we therefore remain short.

Our readings on market **sentiment** suggest equities are poised for a correction over the near term. Many of the indicators we monitor – including investment flows, investor positioning and implied volatility – show that the rally is unsustainable in the absence of a sharp improvement in corporate profits or economic growth. Investment flows testify to a renewed appetite for risk-taking: market participants continue to rotate out of bonds and into equities at a record pace, particularly in emerging market stocks. A similar shift can be seen among hedge funds. Meanwhile, levels of implied volatility – the cost of options that offer insurance against a market decline – have fallen to record lows. Elsewhere, while economic momentum is positive, it would appear that market expectations for future growth are approaching unrealistic levels, particularly in the US. As the chart below shows, the economic surprises index, which tracks the extent to which data releases beat or undershoot consensus forecasts, has recently fallen into negative territory. History shows this tends to be a significant development for US equities – in those instances when the gauge has turned negative, US stocks have fallen 70 per cent of the time in the subsequent three-month period.

Valuations also reinforce our bearish stance on riskier assets. Trading at

ECONOMIC FORECASTS NOW OVERLY-OPTIMISTIC

Citigroup Economic Surprises Index

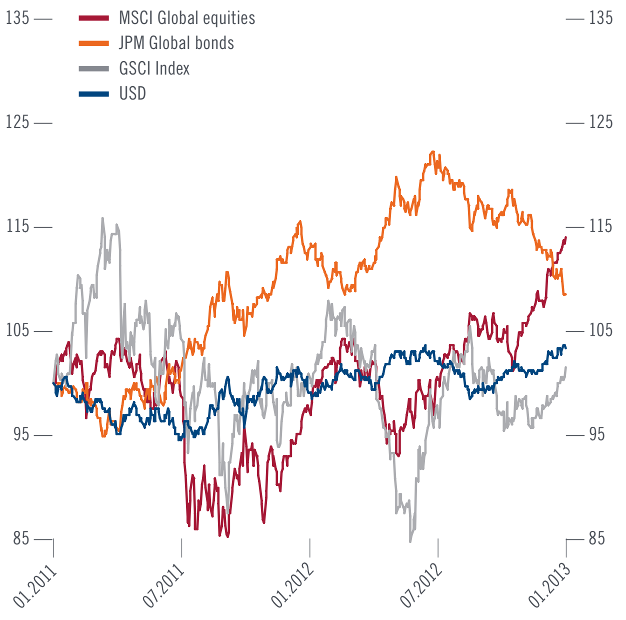


Source: Citigroup

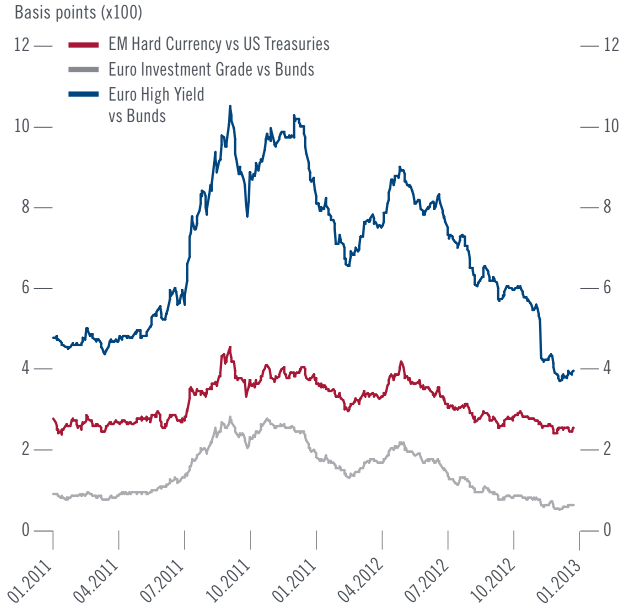
Source: Pictet Asset Management, Thomson Reuters Datastream / JPM and BoA Merrill Lynch

MAJOR ASSET CLASSES

PERFORMANCE: ASSET CLASSES

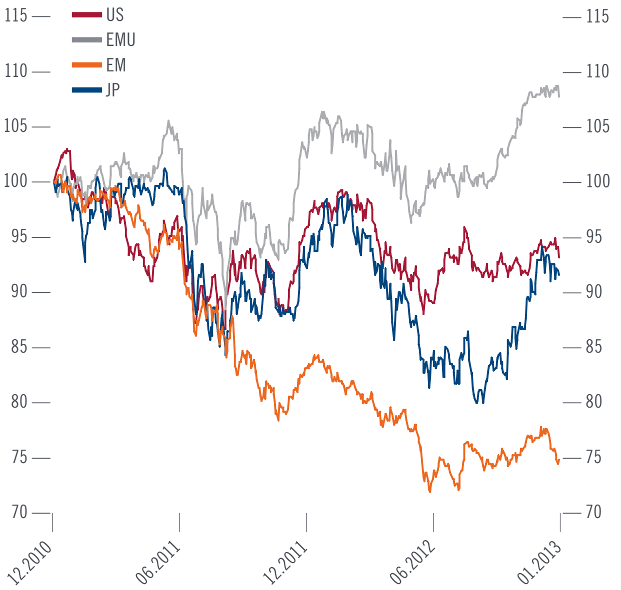


BONDS: ASSET CLASS SPREADS



EQUITY SECTOR ROTATION AND CURRENCY PERFORMANCE

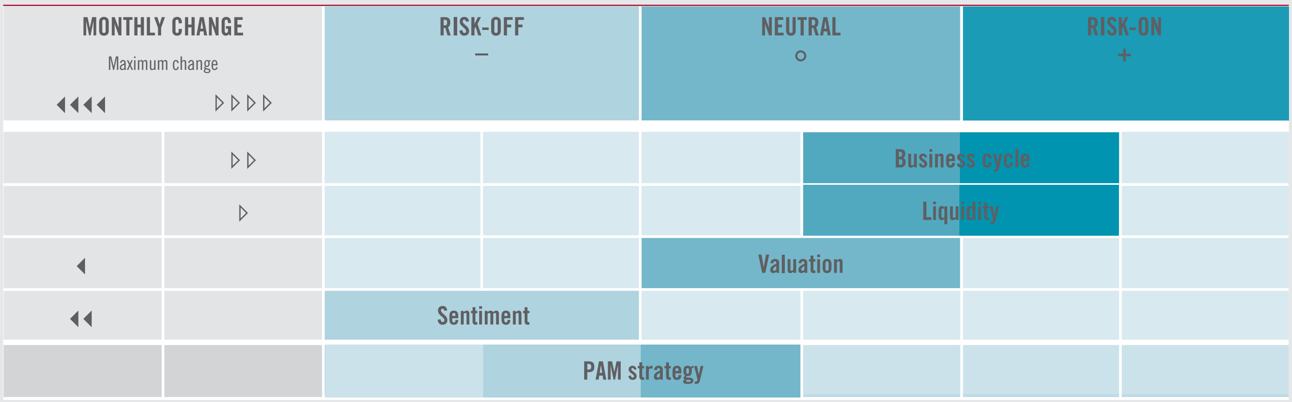
GLOBAL EQUITY SECTOR ROTATION:
PERFORMANCE OF CYCLICAL VS DEFENSIVE STOCKS



PERFORMANCE: CURRENCIES VS USD

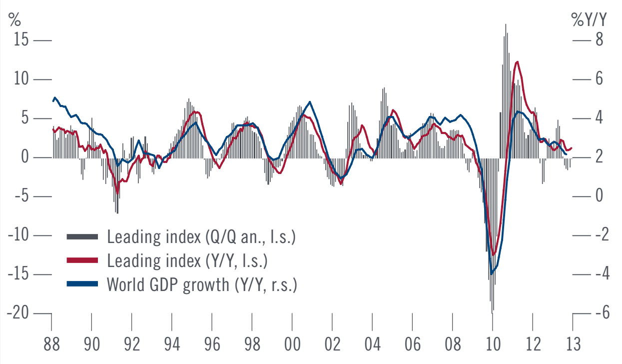
Source: Pictet Asset Management, Thomson Reuters Datastream

RISK BIAS INDICATORS: MONTHLY CHANGE

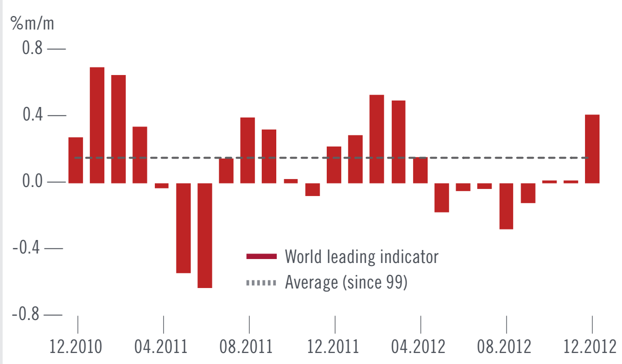


BUSINESS CYCLE: WORLD ECONOMIC ACTIVITY SHOWING SOME IMPROVEMENT

WORLD LEADING ACTIVITY INDEX & REAL GDP GROWTH

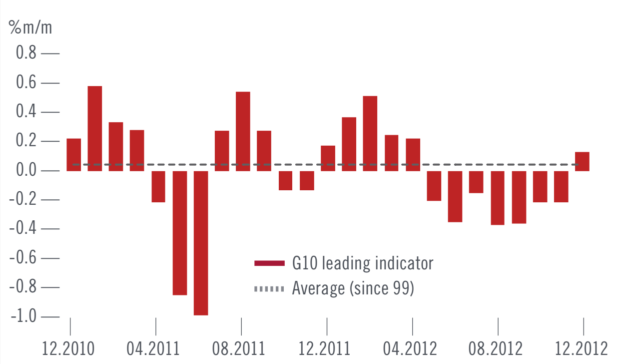


WORLD LEADING ACTIVITY SEQUENTIAL GROWTH (M/M)

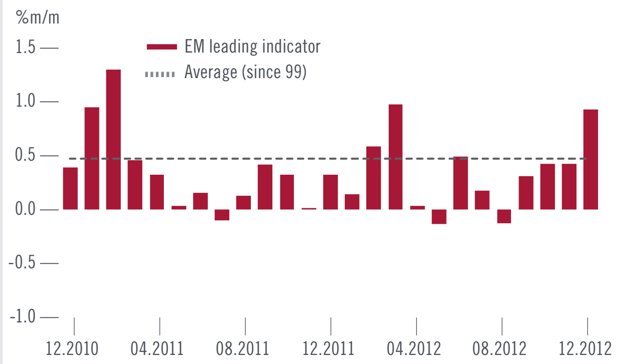


G10 AND EMERGING COUNTRIES SEE SIGNS OF GATHERING ECONOMIC MOMENTUM

G10 LEADING INDICATOR M/M GROWTH



EM LEADING INDICATOR M/M GROWTH



Source: Pictet Asset Management, Thomson Reuters Datastream

VALUATION: EQUITY MARKETS AND SECTORS

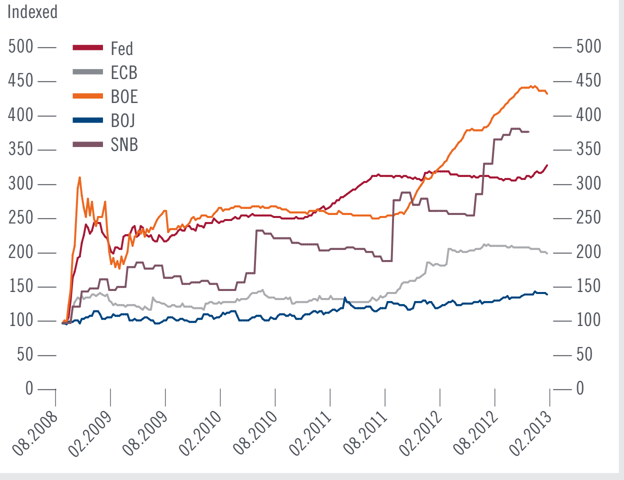
COUNTRIES AND SECTORS

MSCI REGIONS	EPS GROWTH 2012	EPS GROWTH 2013	SALES GROWTH 2012	SALES GROWTH 2013	PE 2012	PE 12M	PB 2012E	P/SALES 2012E	DY 2012E
US	6%	8%	4%	4%	14.7	13.4	2.2	1.4	2.0%
Europe	-4%	9%	2%	3%	13.2	12.0	1.6	1.0	3.5%
EMU	-4%	10%	3%	2%	13.5	12.2	1.4	0.8	3.3%
Switzerland	6%	11%	5%	5%	16.2	14.4	2.4	2.0	3.0%
UK	-8%	7%	-1%	2%	12.3	11.5	1.8	1.1	3.7%
Japan	39%	39%	2%	3%	18.4	13.9	1.1	0.5	2.1%
EM	2%	14%	9%	7%	12.3	10.7	1.6	0.8	2.7%
NJA	8%	14%	8%	8%	13.3	11.6	1.6	0.8	2.5%
Global	3%	11%	4%	4%	14.3	12.8	1.8	1.1	2.6%

MSCI GLOBAL SECTORS	EPS GROWTH 2012	EPS GROWTH 2013	SALES GROWTH 2012	SALES GROWTH 2013	PE 2012	PE 12M	PB 2012E	P/SALES 2012E	DY 2012E
Energy	-9%	5%	1%	1%	11.2	10.6	1.5	0.7	2.9%
Materials	-23%	20%	0%	5%	15.5	12.7	1.7	1.0	2.4%
Industrials	3%	11%	4%	5%	15.2	13.6	2.1	0.8	2.4%
Consumer Discretionary	30%	17%	7%	5%	16.4	14.0	2.3	0.9	1.8%
Consumer Staples	5%	10%	8%	5%	18.1	16.3	3.4	1.1	2.7%
Health care	4%	3%	5%	4%	14.4	13.9	2.9	1.6	2.5%
Financials	8%	12%	4%	4%	13.0	11.4	1.1	1.6	3.0%
IT	12%	11%	4%	7%	14.4	12.7	2.7	1.6	1.4%
Telecoms	-1%	9%	3%	2%	13.6	12.5	1.8	1.2	4.8%
Utilities	17%	9%	3%	3%	15.3	14.2	1.3	0.8	4.5%

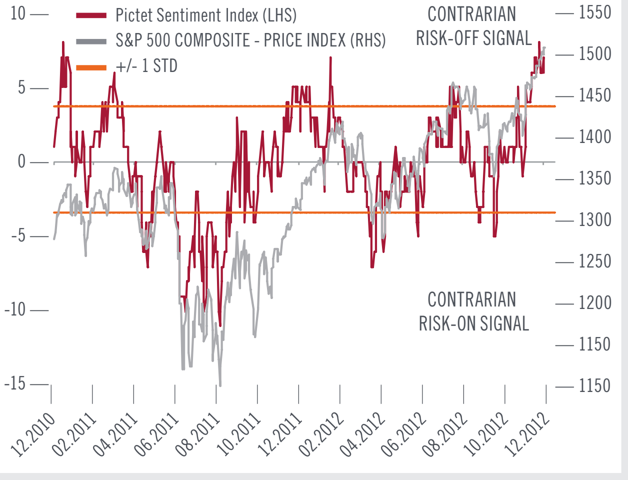
LIQUIDITY: BOOSTED BY EASY MONETARY POLICY

SIZE OF CENTRAL BANKS' BALANCE SHEETS



SENTIMENT READING HIGHLIGHTS POTENTIAL FOR SETBACK

PICTET SENTIMENT CYCLE INDEX

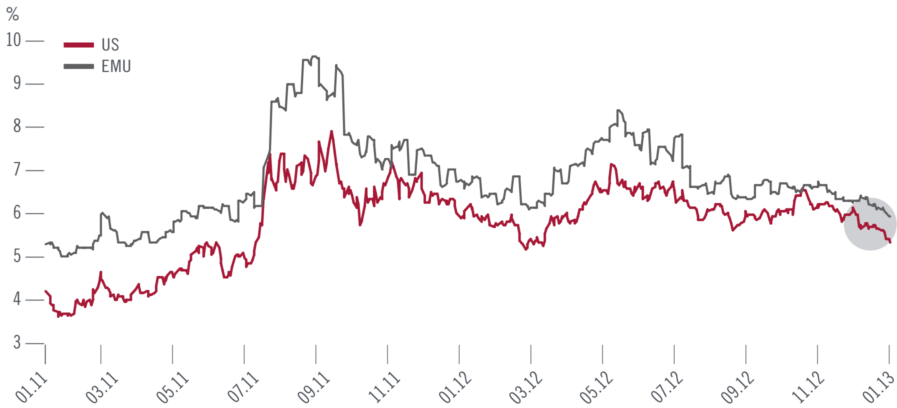


around 12.5 times forward earnings, global stocks now look fairly-valued. The picture is even less compelling when stocks are measured on a price-to-sales or cyclically-adjusted price/earnings basis. At the same time, the consensus forecast for US earnings growth is, at just over 9 per cent, still meaningfully above our own 5 per cent estimate. Moreover, earnings downgrades continue to be a feature of the investment landscape - an unusual occurrence at a time of rising expectations for growth and profits. Japan is the only region to buck that trend. Equities remain attractively valued compared to bonds, but even on this measure, their relative appeal has dimmed as a result of an upward move in government bond yields (see chart). In the US, both the S&P 500 dividend yield and the 10-year Treasury yield are now at 2 per cent.

Our **business cycle** readings point to an acceleration in economic growth worldwide. After seven consecutive months of declines, our world leading economic indicators moved into positive territory in December, largely reflecting a recovery in business spending. The US remains in far better shape than the headline figures from the fourth quarter GDP report suggest – private investment is heading in a positive direction (see chart overleaf), indicating that businesses are upbeat on the prospect of US lawmakers sealing an agreement on public spending cuts.

EQUITY RISK PREMIA FALLS IN BOTH US AND EUROPE

Earnings yield minus 10-year government bond yield



Source: Thomson Reuters Datastream

The euro zone is in a mild recession but there are some positive signals. Germany's business sentiment is improving – the Ifo expectations index showed its biggest rise since 2009 - as is momentum in the country's services sector. The region as a whole may soon feel the benefit of a marked fall in mortgage and business loan rates – borrowing costs have fallen by some 40 to 70 basis points since Mario Draghi became European Central Bank president. Japan's heady mix of monetary and fiscal stimulus, meanwhile, is also a plus for the world's growth prospects. In China, there is growing evidence of a strong recovery, fuelled by robust consumer spending. Risks to growth remain, however, as evidenced by the International Monetary Fund's decision to cut its world growth forecast for 2013. Most of the risks are political in nature. The outcome of budget negotiations in the US remains uncertain while upcoming elections in Italy look increasingly unlikely to deliver the reform-minded government the country requires. Cyprus' financial problems also loom large and may yet lead investors to reassess the risks of the debt crisis.

Our **liquidity** readings, meanwhile, provide some bullish signals. Japan exhibits a sharp improvement in liquidity conditions, courtesy of the BoJ's shift to a higher inflation target and commitment to increase its bond purchase programme. The US, Germany and Switzerland continue to enjoy buoyant liquidity conditions but the euro zone as a whole still suffers from a contraction in bank lending even though borrowing costs for both corporations and households have fallen in recent months.

Equity region and sector allocation

Japan remains attractive but consumer discretionary and IT lose their lustre

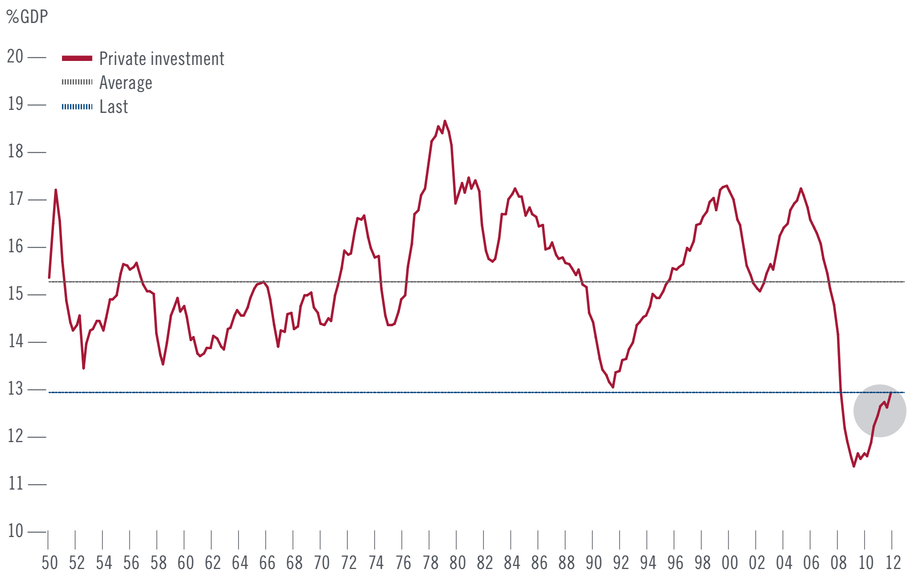
In our view, Japan continues to be the most attractive of the developed equity markets, and we have chosen to increase our overweight stance on the asset class as a result. Japanese equities are cheap compared to their global peers – they trade at a price-to-book ratio of only just above 1 – and they should continue to benefit from the recent weakness of the Japanese yen, whose depreciation comes courtesy of the BoJ's aggressive monetary policy. Moreover, thanks partly to a fiscal boost from the new prime minister Shinzo Abe, the Japanese economy appears poised for recovery – it is also the only major market where corporate earning forecast upgrades outnumber downgrades. The fact that Japanese stocks exhibit a very low correlation to global equities is another plus.

By contrast, the outlook for European equities is discouraging – stock valuations are high, earnings forecasts are overly-optimistic and the European Central Bank is beginning to reduce the size of its balance sheet. The euro is also strong – trading at around USD1.35, the currency's resilience reduces the prospect of an export-led recovery. Against this backdrop, we have reduced our stance on European stocks to a full underweight.

Emerging markets, where our leading indicators show positive momentum, are meanwhile on watch for upgrade. At the same time, we have also cut our exposure to small-cap stocks to a single underweight.

When it comes to our sector allocation, we have scaled back some of our exposure to cyclical stocks in favour of some more defensive positions. We have chosen to take profits on our consumer discretionary overweight, moving it to neutral as US consumer confidence is faltering at a time when such stocks are trading at all time highs. We have also reduced our exposure to information technology to neutral amid signs that demand for new products from some of the sector's bellwethers is not living up to expectations. By contrast, the outlook for industrials has brightened somewhat as we see evidence of a pick-up in capital spending (see chart); we have therefore reduced our underweight position in the sector. We have a preference for defensive sectors with good growth prospects such as consumer staples and health care and we have upgraded the latter to a full overweight. We have also raised utilities to overweight as it is a sector that scores very positively on valuations and earnings momentum.

US PRIVATE INVESTMENT RECOVERING



Source: Thomson Reuters Datastream

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Fixed Income

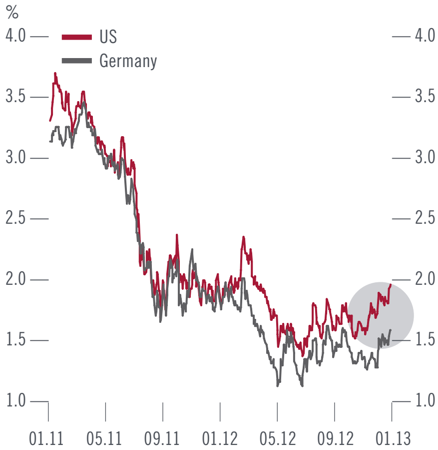
Yield spike provides opportunity to increase duration

The recent spike in government bond yields in the US and Germany looks difficult to justify: inflationary pressures are moderate, the world's major central banks are committed to supporting debt markets and economic growth, while improving, remains weak by historical standards.

In our view, markets have attached too much significance to the apparently hawkish shift in ECB rhetoric – it is difficult to believe the central bank would tighten policy with the euro zone in recession and the single currency trading at levels that hampers an export-led recovery. (The OECD estimates that the euro zone GDP growth is reduced by 0.7 percentage points for every 10 per cent gain in the currency.)

For these reasons, we have extended our duration in core bond markets such as Germany and the US. We have, however, further reduced our exposure to investment-grade credit, largely on valuation grounds. We continue to see value in speculative-grade and emerging market debt. Default risk in high-yield bonds remains low by historical standards and issuers continue to exhibit a high degree of financial discipline – a reassuring signal for investors on the lookout for yield.

GOVERNMENT BOND YIELDS RATCHET HIGHER



Source: Bloomberg

That said, investment flows into the asset class will need to be closely monitored.

We are more optimistic on emerging market bonds, especially local currency debt, which should benefit from currency appreciation. Easy monetary policy in the developed world increases the allure of higher-yielding currencies while the developing world's better growth prospects should also serve as a magnet for foreign investors.

As far as currency positioning is concerned, we retain an underweight stance on both the euro and the Japanese yen. The euro has risen to values well above its intrinsic (PPP) value and net speculative positions have turned positive, a sign that further appreciation is unlikely. The strength of the euro appears to reflect a widespread conviction that the euro zone debt crisis is now well under control – a view that we do not subscribe to given the risk attached to Italy's general election, among other things.

Olivier Ginguené, *Chairman*
Pictet Asset Management Strategy Unit

Luca Paolini, *Chief strategist*
Pictet Asset Management

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, multiples vs. history
- **sentiment:** Pictet sentiment index (investors' surveys, tactical indicators)